The Institute of Chartered Accountants in England and Wales

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Workbook

For exams in 2021

icaew.com

Financial Management

The Institute of Chartered Accountants in England and Wales

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Contents

Questions within the Workbook should be treated as preparation questions, providing you with a firm foundation before you attempt the exam-standard questions. The exam-standard questions are found in the Question Bank.

Welcome to ICAEW

I'd like to personally welcome you to ICAEW.

In a fast-changing and volatile world, the role of the accountancy profession has never been more important.

As an ICAEW Chartered Accountant, you will make decisions that will define the future of global business.

By choosing our world-leading chartered accountancy qualification, the ACA, you will acquire exceptional knowledge and skills – with technology and ethics at the heart of your learning. A focus on capabilities such as judgement and scepticism will enable you to make the right decisions in diverse and often complex environments.

You will be equipped to flourish and to lead in areas that are transforming the business landscape. This includes embracing technological change and harnessing digital disruption, to help our profession deliver greater value. It also includes putting climate change and sustainability at the heart of business strategy. We will equip you to be adaptable and agile in your work and all within a set of values fundamental to trust and transparency, which will set you apart from others.

Joining over 184,500 ICAEW Chartered Accountants and students worldwide, you are now part of a global community. This unique network of talented and diverse professionals work in the public interest to build economies that are sustainable, accountable and fair.

You are also joining a community of 1.8m chartered accountants and students as part of Chartered Accountants Worldwide – a family of leading institutes, of which we are a founder member.

ICAEW will support you through your studies and throughout your career: this is the start of a lifetime relationship, and we will be with you every step of the way to ensure you are ready to face the challenges of the global economy. Visit page v to review the key resources available as you study.

With our training, guidance and support, you will join our members in realising your career ambitions, developing world-leading insights and maintaining a competitive edge.

We will create a world of strong economies, together.

I wish you the best of luck with your studies.

Michael Izza

Chief Executive

ICAEW

Financial Management

If you are studying this exam as part of the ACA qualification go to icaew.com/examresources or if you are studying the ICAEW CFAB qualification go to icaew.com/cfabstudents.

Module aim

Financial Management enables students to recommend relevant options for financing a business, recognise and manage financial risks and make appropriate investment decisions.

On completion of this module, students will be able to:

- identify capital requirements of businesses, assess financing options and recommend relevant methods of financing;
- identify the financial risks facing a business and the principal methods of managing those risks; and
- apply appropriate investment appraisal techniques taking into account other factors affecting investment decisions.

Method of assessment

The Financial Management module exam is 2.5 hours long. The exam consists of three questions. Managing financial risk will be assessed as a discrete topic. The other two questions will assess financing options and investment decisions and valuation either as discrete or integrated topics.

Specification grid

This grid shows the relative weightings of subjects within this module and should guide the relative study time spent on each. Over time the marks available in the assessment will equate to the weightings below, while slight variations may occur in individual assessments to enable suitably rigorous questions to be set.

	Weighting (%)
1 Financing options	35
2 Managing financial risk	30
3 Investment decisions and valuation	35

Permitted texts

At the Professional and Advanced Levels there are specific texts that you are permitted to use during your exam. All information for these texts is available on icaew.com/permittedtexts.

Professional level exams	Permitted text
Audit and Assurance	✔
Financial Accounting and Reporting	✔
Tax Compliance	✔
Business Strategy and Technology	x
Financial Management	x
Business Planning	No restrictions

Advanced Level exams	
Corporate Reporting	No restrictions
Strategic Business Management	No restrictions
Case Study	No restrictions

The exams which have no restrictions include the following:

- Business Planning: Banking;
- Business Planning: Insurance;
- Business Planning: Taxation;
- Corporate Reporting;
- Strategic Business Management; and
- Case Study.

This information, as well as what to expect and what is and is not permitted in each exam is available in the Instructions to Candidates. You will be sent the instructions with your exam admission details. They can also be viewed on our website at icaew.com/exams.

Key resources

Whether you're studying the ACA qualification with an employer, at university, independently (self-studying), or as part of an apprenticeship, we provide a wide range of resources and services to help you in your studies.

Take a look at the online exam resources available to you on icaew.com/examresources and discover more resources and services at icaew.com/studentbenefits.

Syllabus, skills development and technical knowledge grids

This syllabus presents the learning outcomes for each exam and should be read in conjunction with the relevant technical knowledge grids and, where applicable, the skills development grids.

Exam support

A variety of exam resources and support have been developed on each exam to help you on your journey to exam success. This includes exam guidance, sample exams, hints and tips from examiners and tutors, on-demand webinars and articles.

Past exams and mark plans

Use past exams to practise answering questions. The mark plans will help you check your answers. The past exams and mark plans are included in your Question Bank and have been updated to reflect the 2021 legislation and syllabus.

Errata sheets

These documents will correct any omissions within the learning materials once they have been published. You should refer to them when studying.

Exam software

It is vital that you are familiar with the exam software before you take your exam. Access a variety of resources, including the practice software and sample exams at icaew.com/studentresources.

Student support team

Our student support team is here to help and advise you, so do not hesitate to get in touch. Email studentsupport@icaew.com or call +44 (0)1908 248 250. If you are browsing our website, look out for the live help boxes. You will be able to speak directly to an adviser. Mia, our ChatBot, is also on hand to answer your queries.

Online student community

The online student community is the place where you can post your questions and share your study tips. Join the conversation at icaew.com/studentcommunity.

ICAEW Quarterly and Student Insights

As an ACA student, you will also receive a copy of our member magazine, *Quarterly*. Read more at icaew.com/insights.

You'll also be able to access our practical and topical student content on our dedicated online student hub, Student Insights.

You'll find new-look features, interviews and guides giving you fresh insights, innovative ideas and an inside look at the lives and careers of our ICAEW students and members. No matter what stage you're at in your journey with us, you'll find content to suit you.

Tuition

The ICAEW Partner in Learning scheme recognises tuition providers who comply with our core principles of quality course delivery. If you are not receiving structured tuition and are interested in doing so, take a look at ICAEW recognised Partner in Learning tuition providers in your area at icaew.com/dashboard.

CABA

It can be tough juggling your studies with work, planning for the future and finding time to unwind. CABA are an independent charity that supports the well-being of the chartered accountant community. So, if you need support at home or at work, CABA is there for you. They provide information, advice and lifelong support to ACA students across the world face-to-face, over the phone and online. All their services are completely free and strictly confidential. Find out more at caba.org.uk.

ICAEW Business and Finance Professional (BFP)

ICAEW Business and Finance Professional (BFP) is an internationally recognised designation and professional status. It demonstrates your business knowledge, your commitment to professionalism and that you meet the standards of a membership organisation. Once you have completed the ICAEW CFAB qualification or the ACA Certificate Level, you are eligible to apply towards gaining BFP status. Start your application at icaew.com/becomeabfp.

Skills within the ACA

Professional skills are essential to accountancy and your development of them is embedded throughout the ACA qualification.

The level of competency required in each of the professional skills areas to pass each module exam increases as ACA trainees progress upwards through each Level of the ACA qualification. The skills progression embedded throughout the ACA qualification ensures ACA trainees develop the knowledge and professional skills necessary to successfully operate in the modern workplace and which are expected by today's forward-thinking employers.

The following professional skills areas are present throughout the ACA qualification.

Skill area	Overall objective
Assimilating and using information	Understand a business or accounting situation, prioritise by determining key drivers, issues and requirements and identify any relevant information.
Structuring problems and solutions	Structure information from various sources into suitable formats for analysis and provide creative and pragmatic solutions in a business environment.
Applying judgement	Apply professional scepticism and critical thinking to identify faults, gaps, inconsistencies and interactions from a range of relevant information sources and relate issues to a business environment.
Concluding, recommending and communicating	Apply technical knowledge, skills and experience to support reasoning and conclusion and formulate opinions, advice, plans, solutions, options and reservations based on valid evidence and communicate clearly in a manner suitable for the recipient.

The following provides further detail on the professional skills that you will develop in this particular module. To see the full skills development grids, please go to icaew.com/examresources.

Assimilating and using information

Understand the situation and the requirements

- Demonstrate understanding of the business context
- Recognise new and complex ideas within a scenario
- Identify the needs of customers and clients
- Explain different stakeholder perspectives and interests
- Identify risks within a scenario
- Identify elements of uncertainty within a scenario
- Identify ethical issues including public interest and sustainability issues within a scenario

Identify and use relevant information

- Interpret information provided in various formats
- Evaluate the relevance of information provided
- Use multiple information sources
- Filter information provided to identify critical facts

Identify and prioritise key issues and stay on task

- Identify business and financial issues from a scenario
- Prioritise key issues
- Work effectively within time constraints
- Operate to a brief in a given scenario

How skills are assessed: students may be required to:

- absorb and understand both structured and unstructured material; and

- give recommendations based on their understanding and interpretation of the information provided, supported by explanation of the reasoning behind and implications of their recommendations.

Structuring problems and solutions

Structure data

- Structure information from various sources into suitable formats for analysis
- Identify any information gaps
- Frame questions to clarify information
- Use a range of data types and sources to inform analysis and decision making
- Structure and analyse financial and non-financial data to enhance understanding of business issues and their underlying causes
- Present analysis in accordance with instructions and criteria

Develop solutions

- Identify and apply relevant technical knowledge and skills to analyse a specific problem
- Use structured information to identify evidence-based solutions
- Identify creative and pragmatic solutions in a business environment
- Identify opportunities to add value
- Identify and anticipate problems that may result from a decision
- Identify a range of possible solutions based on analysis
- Identify ethical dimensions of possible solutions
- Select appropriate courses of action using an ethical framework
- Identify the solution which is the best fit with acceptance criteria and objectives
- Define objectives and acceptance criteria for solutions

How skills are assessed: students may be required to:

- assimilate significant amounts of information, to analyse it (including quantitative analysis) in a way that demonstrates relevant technical knowledge and to draw and support appropriate conclusions.

Applying judgement

Apply professional scepticism and critical thinking

- Recognise bias and varying quality in data and evidence
- Identify assumptions or faults in arguments
- Identify gaps in evidence
- Identify inconsistencies and contradictory information
- Assess interaction of information from different sources
- Exercise ethical judgement

Relate issues to the environment

- Appreciate when more expert help is required
- Identify related issues in scenarios
- Assess different stakeholder perspectives when evaluating options
- Retain an overview of the business issue or scenario
- Appraise corporate responsibility and sustainability issues
- Appraise the effects of alternative future scenarios
- Appraise ethical, public interest and regulatory issues

How skills are assessed: students may be required to:

- make sense of relatively large volumes of data, making judgments on the relevance of data for use in subsequent calculations and discussions;
- reflect on their calculations and the methodology employed and to identify and discuss the implications of calculations; and

- make and justify judgements based on earlier calculations.

Concluding, recommending and communicating

Conclusions

- Apply technical knowledge to support reasoning and conclusions
- Apply professional experience and evidence to support reasoning
- Use valid and different technical skills to formulate opinions, advice, plans, solutions, options and reservations

Recommendations

- Present recommendations in accordance with instructions and defined criteria
- Make recommendations in situations where risks and uncertainty exist
- Formulate opinions, advice, recommendations, plans, solutions, options and reservations based on valid evidence
- Make evidence-based recommendations which can be justified by reference to supporting data and other information
- Develop recommendations which combine different technical skills in a practical situation

Communication

- Present a basic or routine memorandum or briefing note in writing in a clear and concise style
- Present analysis and recommendations in accordance with instructions
- Communicate clearly to a specialist or non-specialist audience in a manner suitable for the recipient
- Prepare the advice, report, or notes required in a clear and concise style

How skills are assessed: students may be required to:

- recommend suitable courses of action in a given situation (financing decisions, dividend decisions, investment appraisal decisions); and
- incorporate advice within a 'business report' format, addressing both the strengths and weaknesses of any recommendations and/or reasons for the rejection of alternatives.

To help you develop your ability to demonstrate competency in each professional skills area, each chapter of this Workbook includes up to four Professional Skills Guidance points.

Each Professional Skills Guidance point focuses on one of the four ACA Professional Skills areas and explains how to demonstrate a particular aspect of that professional skill relevant to the topic being studied. You are advised to refer back to the Professional Skills Guidance points while revisiting specific topics and during question practice.

Chapter 1

Corporate governance

Introduction

Learning outcomes

- Explain the responsibility of those charged with governance for managing risk and assess the role of assurance in risk mitigation
- Assess the nature of governance and explain the characteristics and principles of good governance in a variety of scenarios
- Assess the interests and impact of organisational stakeholders in determining strategy and the consequences for stakeholders of strategic choices
- Evaluate the impact of governance mechanisms on a range of stakeholders
- Assess and advise on appropriate corporate governance mechanisms, and evaluate stakeholder management
- Analyse and evaluate the strengths and weaknesses of corporate governance mechanisms and processes
- Evaluate the suitability of corporate governance and organisational structures for implementing strategy
- Explain the role of boards in monitoring corporate performance and risk, and assess the role of assurance procedures in this context
- Explain the nature, and assess the consequences, of the legal framework within which businesses, assurance and governance systems operate (with particular reference to company law, fraud, money laundering, civil liabilities, social security law, employment law, contract law, tort and environmental law)

Specific syllabus references for this chapter are: 6c, 7a – 7e, 7g – 7i

Knowledge brought forward and syllabus links

Corporate governance was covered briefly in Business Strategy and Technology and is also covered in depth in Corporate Reporting. However, this chapter focuses on the effectiveness of governance by firstly looking at what governance is trying to achieve and the problems it is trying to address. We have already discussed the importance and general concerns of stakeholders in Chapter 1 and in this chapter we look at how important they are in the context of governance. The role of the board and whether the board appears to be operating effectively (or is able to operate effectively) is central to this chapter. Whether the organisational structure can effectively support the achievement of governance objectives is the other important issue.

The chapter ends with what is mainly a recap of law issues covered in other material, that has been included to set governance in its legal context. We also discuss the importance of the organisation having structures and procedures in place to ensure compliance.

Examination context

The learning outcomes of assessing and advising on corporate governance mechanisms and evaluating their strengths and weaknesses indicate that you will have to make judgements about how strong and appropriate governance mechanisms are, and highlight key weaknesses that may undermine their effectiveness.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1		**Approach**		

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	Principles of governance Prompted by concerns and scandals in the early 1990s, corporate governance guidance has developed considerably over the last three decades. However, many corporate governance debates remain ongoing, particularly as to whether guidance should take the form of a rules-based or principles-based approach. Some areas, for example board diversity, have been seen as increasingly important in the last few years.	Section 1 sets the scene for this chapter and shows what has influenced the development of best practice, as well as identifying the principles of good corporate governance. Note the various mechanisms that make up an organisation's corporate governance structure. **Stop and think** How many of the provisions in corporate governance guidance, such as the UK Corporate Governance Code, apply mainly to large listed companies, and how many apply to all companies?	SBM requires practical application of theory to the scenario. Exam questions may therefore ask you to assess the strengths and weaknesses of corporate governance arrangements in an organisation and to suggest improvements where necessary.	
2	**Stakeholders** Directors and managers should be aware of the interests of stakeholders in governance. The current version of the Code puts the relationships between companies, shareholders and stakeholders at the heart of long-term sustainable growth.	**Approach** Section 2 deals with all those who have a stake in corporate governance and whose views must be taken into account. The 'comply or explain' requirement is an important one that has been adopted widely. **Stop and think** Why should small investors be treated the same as larger institutional investors when it comes to corporate	Exam questions may expect you to discuss how corporate governance arrangements impact upon shareholders and other stakeholders. You may also need to consider how corporate governance itself is likely to be influenced by shareholder and stakeholder concerns.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		governance?		
3	**Role of boards** The effectiveness of the board as a mechanism for governance depends on the composition and balance of the board. The UK Corporate Governance Code sets standards of good practice in relation to: board leadership; division of responsibilities; composition of the board and evaluation of the board's performance; risk and control; and remuneration.	**Approach** Spend the majority of your time on this section, as the role of the board is central to how well the organisation is governed. **Stop and think** What aspects of diversity are most important for a board?	This is the most examinable section of the chapter. Exam questions may ask you to analyse the responsibilities and performance of board members and board committees or to advise management on steps it can take to ensure compliance with corporate governance best practice.	**IQ1: Recruitment of non-executive directors** In this question you are presented with three nominees to replace two of the existing non-executive directors. You are asked to evaluate the suitability of the nominees; in an evaluation it is good practice to look at the arguments in favour of and against each of the nominees. **IQ2: Audit committee** In this question you are asked to examine two aspects of corporate governance; the limitations of relying on non-executive directors to improve corporate governance and how to enhance the effectiveness of audit committees. **IQ3: Internal control review** This short question is designed to encourage you to generate ideas. There are two tasks. Firstly, consider the type of information

Topic	Practical significance	Study approach	Exam approach	Interactive questions
				needed to help the board carry out a review of internal control. Secondly, consider the specific employee attitudes that would help or hinder a review of internal control.
4	**Organisational structures and strategies** Corporate governance needs to be seen in wider contexts, both internally in relation to how organisations are structured, and externally, with regard to operating in an environment where the legal demands on the business are weighty. The effectiveness of governance arrangements may depend upon how well organisational strategy matches strategic and governance aims.	**Approach** Section 4 can be covered briefly – try to link it in with what you have studied in Business Strategy and Technology. **Stop and think** What can the board and senior managers do to encourage a positive culture that supports good corporate governance?	Exam questions may look at the effectiveness and appropriateness of corporate governance. You may therefore be asked to advise on the appropriateness of the structure for governance purposes, considering the size of the entity, the risks it is exposed to and the degree of decentralisation.	
5	**Legal framework of governance**. Companies are increasingly subject to laws and regulations with which they must comply. Boards must be aware of these laws and their impact on the organisation so that they can put in place controls to ensure compliance.	**Approach** You can read through this section fairly quickly. You need a general awareness of UK legislation that section 5 provides, but you are not expected to have a detailed knowledge of UK legislation. **Stop and think**	In the exam you will not be required to cite detailed laws and regulations. However, it is important to have a basic awareness of issues such as fraud, bribery, insider trading and money laundering. You may also be required to advise on practical steps the board can take to encourage a culture of compliance.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		What factors lead to an increased risk of bribery or corruption?		

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Principles of governance

Section overview

Good corporate governance involves risk management and internal control, accountability to shareholders and other stakeholders, and conducting business in an ethical and effective way.

Definition

Corporate governance: Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring.

(*OECD Principles, 2004, Preamble*)

The aim of corporate governance should be to facilitate effective, entrepreneurial and prudent management that can deliver the long-term, sustainable success of the entity in achieving its objectives and creating value for its owners (shareholders). Key issues in corporate governance are the effectiveness of the leadership provided by the board of directors and the accountability of the board to the shareholders and other stakeholders for company performance and objectives.

Context example: Context example: Stakeholder pressures

Hermes Pensions Management Ltd, a leading UK institutional investor, introduced the Hermes principles in 2002. Hermes advocates that companies should be able to demonstrate that their investment decisions show ethical behaviour and have regard for the environment and society as a whole.

The first Hermes principles stated that companies should effectively manage relationships with their employees, suppliers and customers and with others who have a legitimate interest in the company's activities. They also required companies to support voluntary and statutory measures that minimise the externalisation of costs to the detriment of society at large. Businesses should thus not seek success at society's expense. The later principles issued by Hermes stated that socially, ethically and environmentally responsible behaviour should be part of the management process that companies should carry out to maximise shareholder value.

The Association of British Insurers also issues guidance on socially responsible investment. Its focus is managing risks that may affect business value arising from social, environmental and ethical issues. Effective risk management could have the upside of enhancement of value. The guidelines emphasise the importance of effective information flows, and performance measurement systems and appropriate remuneration systems being part of risk management. Policies and procedures should be disclosed within the annual report and not in a separately published document.

Although mostly discussed in relation to large quoted companies, good corporate governance is an issue for all corporate bodies, both commercial and not for profit. In the UK, for example, the UK Corporate Governance Code applies to premium listed companies, but there is also a Quoted Companies Alliance Code for smaller quoted companies, the Wates Corporate Governance

Principles for large private companies, and codes of governance for central government, local government authorities and charities.

The details of codes of corporate governance vary by country, and there is no single model of 'good governance'. However, underlying any governance models or codes is the logic that good governance is required to create an environment of market confidence and business integrity.

In turn, this will help to reassure shareholders and other stakeholders their rights are protected, reducing the cost of capital and support entities' access to the capital market.

The G20/OECD Principles of Corporate Governance (2015) provide an international benchmark for policy makers and institutions. The Principles are based on the underlying logic that a high level of transparency, accountability, board oversight and respect for the rights of the shareholders and the role of key stakeholders are key parts of a well-functioning corporate governance system.

The International Corporate Governance Network (ICGN) also offers a supranational perspective on corporate governance, and its Global Governance Principles highlight eight key principles of effective governance.

Context example: Context example: Principles of Corporate Governance

OECD Principles of Corporate Governance

The OECD's Principles are not intended as detailed prescriptions, but instead aim to provide a reference which policy makers can use to develop their own corporate governance framework. The OECD Principles (2015) include six main points:

(a) **Transparency and fairness**

The corporate governance framework should promote transparent and fair markets, and the efficient allocation of resources. It should be consistent with the rule of law and support effective supervision and enforcement.

(b) **Shareholders' rights**

The corporate governance framework should protect and facilitate the exercise of shareholders' rights, and ensure the equitable treatment of all shareholders, including minority and foreign shareholders.

(c) **Investors and stock markets**

The corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance.

(d) **The role of stakeholders in corporate governance**

The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements, and encourage active co-operation between companies and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises.

(e) **Disclosure and transparency**

Timely and accurate disclosure should be made on all material matters regarding the company, including its financial situation, performance, ownership and governance.

(f) **Board responsibilities**

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

ICGN Global Governance Principles

(a) **Board role and responsibility** – The board should act on an informed basis – with good faith, care and diligence – in the best long-term interests of the company, for the benefit of shareholders but with regard to the interests of other relevant stakeholders.

(b) **Leadership and independence** – Board leadership requires clarity and balance in board and executive roles, and an integrity of process to promote the success of the company as a whole, as well as the interests of minority investors.

(c) **Composition and appointment** – There should be a sufficient mix of directors with relevant knowledge, independence, competence, industry experience and diversity of perspectives to generate effective challenge, discussion and objective decision-making.

(d) **Corporate culture** – The board should adopt high standards of business ethics, ensuring that a company's vision, mission and objectives are sound and reflect its values. Codes of conduct should be communicated effectively and integrated into the company's strategy and operations, including its risk management systems and remuneration structures.

(e) **Risk oversight** – The board should proactively oversee, review and approve the approach to risk management, and should satisfy itself that the approach is functioning effectively.

(f) **Remuneration** – Remuneration should be designed to align the interests of the CEO and executive directors with those of the company and its shareholders, to help ensure long-term performance and sustainable value creation. Aggregate remuneration should be appropriately balanced with the needs to pay dividends to shareholders and retain capital for future investment.

(g) **Reporting and audit** – The board should oversee timely and high quality disclosures for investors and other stakeholders – relating to financial statements, strategic and operational performance, corporate governance, and significant environmental and social factors. A robust audit practice is critical for necessary quality standards.

(h) **Shareholder rights** – The rights of all shareholders should be equal and must be protected. Shareholder voting rights must be directly linked to the shareholder's economic stake in the company. Minority shareholders must have voting rights on key decisions or transactions which affect their interest in the company.

There are a number of elements in corporate governance:

(a) Creating an **effective board of directors**: an effective board depends on the leadership provided by the chairman (supported by the company secretary), the balance and composition of the board membership, and decision-making by the board

(b) The **accountability** of the board to the company's shareholders and other stakeholders, through financial reporting, other reporting and the AGM

(c) The effectiveness of **risk management** (strategic risk) and internal control systems

(d) **Remuneration** of directors and senior executives

(e) **Relationships** between the company and its **shareholders**, with investors engaging constructively with a company and discussing any departures from recommended practice

(f) The **ethical conduct** of the company, including its policies on corporate social responsibility and sustainability

2.1 Principles of corporate governance

High standards of corporate governance should be based on a number of fundamental principles.

(a) **Responsibility**. The leaders of a company (directors) should accept responsibility for acting in the best interests of the company so as to achieve the company's objectives (whatever these might be).

(b) **Accountability**. The board of directors should be fully accountable to the company's shareholders (and other stakeholders). Within the company, executive management should be properly accountable to the board of directors.

(c) **Integrity and honesty**. Companies should operate in a way that displays fairness and honesty in their dealings. Good corporate governance has a strong ethical element.

(d) **Transparency**. Through reporting or other methods of communication companies should be open and transparent about their policies and objectives, as well as past performance.

2.1.1 UK Corporate Governance Code 2018

As noted earlier, although frameworks such as the OECD Principles of Corporate Governance provide a benchmark, governance codes and approaches to governance can vary in different countries.

In the UK, companies with a premium listing should be guided by the UK Corporate Governance Code (as revised in July 2018).

The Code emphasises the value of good corporate governance as a contributing factor to long-term sustainable success, and identifies a set of key Principles which help to define good governance.

Context example: Context example: Principles of the UK Corporate Governance Code

Board Leadership and Company Purpose:

(a) A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society.

(b) The board should establish the company's purpose, values and strategy and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example, and promote the desired culture.

(c) The board should ensure that the necessary resources are in place for the company to meet its objectives and measure performance against them. The board should also establish a framework of prudent and effective controls which enable risk to be assessed and managed.

(d) In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties.

(e) The board should ensure that workforce policies and practices are consistent with the company's values and support its long-term sustainable success. The workforce should be able to raise any matters of concern.

Divisions of Responsibilities

(f) The chair leads the board and is responsible for its overall effectiveness in directing the company. They should demonstrate objective judgement throughout their tenure and promote a culture of openness and debate. In addition, the chair facilitates constructive board relations and the effective contribution of all non-executive directors, and ensures that directors receive accurate, timely and clear information.

(g) The board should include an appropriate combination of executive and non-executive (and, in particular, independent non-executive) directors, such that no one individual or small group of individuals dominates the board's decision-making. There should be a clear division of responsibilities between the leadership of the board and the executive leadership of the company's business.

(h) Non-executive directors should have sufficient time to meet their board responsibilities. They should provide constructive challenge, strategic guidance, offer specialist advice and hold management to account.

(i) The board, supported by the company secretary, should ensure that it has the policies, processes, information, time and resources it needs in order to function effectively and efficiently.

Composition, Succession and Evaluation

(j) Appointments to the board should be subject to a formal, rigorous and transparent procedure, and an effective succession plan should be maintained for board and senior management. Both appointments and succession plans should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths.

(k) The board and its committees should have a combination of skills, experience and knowledge. Consideration should be given to the length of service of the board as a whole and membership regularly refreshed.

(l) Annual evaluation of the board should consider its composition, diversity and how effectively members work together to achieve objectives. Individual evaluation should demonstrate whether each director continues to contribute effectively.

Audit, Risk and Internal Control

(m) The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity of financial and narrative statements.

(n) The board should present a fair, balanced and understandable assessment of the company's position and prospects.

(o) The board should establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives.

Remuneration

(p) Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. Executive remuneration should be aligned to company purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy.

(q) A formal and transparent procedure for developing policy on executive remuneration and determining director and senior management remuneration should be established. No director should be involved in deciding their own remuneration outcome.

(r) Directors should exercise independent judgement and discretion when authorising remuneration outcomes, taking account of company and individual performance, and wider circumstances.

Source: Financial Reporting Council (FRC), *UK Corporate Governance Code 2018*.

The Listing Rules require companies to explain how they have applied the Principles, so that – in turn – shareholders can evaluate how effectively the Principles have been applied.

In this respect, the quality of a company's reporting is important, in order to allow shareholders to evaluate how the Principles have been applied, and the company's governance practices.

However, the Code sets out Principles rather than a rigid set of rules, so it offers boards and companies flexibility by allowing them to 'comply or explain' with the Principles. This also means shareholders and investors need to assess a company's approach thoughtfully, and – particularly if a company has not complied with a Principle – to determine whether (or not) they are satisfied the company's governance practices are contributing to its sustainable success and helping it achieve its strategic objectives.

As such, investors as well as directors have an important role in governance. Investors should engage constructively with companies, and discuss with them any departures from recommended practice and the companies' rationale for these.

2.1.2 Reporting by AIM companies

The UK Corporate Governance Code applies to companies with a premium listing on the main market. However, companies with an AIM listing also need to report on their application of a recognised corporate governance code. AIM companies are required to include:

- details of a recognised corporate governance code that the board of directors of the company has decided to apply;
- how the company complies with that code; and
- where it departs from its chosen code, an explanation of the reasons for doing so ('comply or explain').

This information should be reviewed annually.

This reflects the statement in AIM Notice 50 that: "The London Stock Exchange considers that good standards of corporate governance are a significant contribution to a company's long term success. Accordingly, AIM companies and nominated advisers are reminded that good corporate governance is supported by a meaningful explanation of the company's practices against the principles of the chosen code, rather than simply identifying areas of non-compliance."

While the AIM Rules themselves do not specify what a 'recognised corporate governance code' is, AIM Notice 50 indicates that an AIM company should comply or explain against a code of corporate governance that is "appropriate for a company admitted to a public market" and includes examples of existing codes, such as the Financial Reporting Council's UK Corporate Governance Code. Overseas companies with an AIM listing, or companies with a second listing on an overseas market, may consider it more appropriate to report using an appropriate code from a foreign jurisdiction.

2.2 Corporate governance mechanisms

A corporate governance structure combines controls, policies and guidelines that drive the organisation towards its objectives. It is a combination of various mechanisms.

2.2.1 Internal mechanisms

The most important set of controls for an organisation comes from its internal mechanisms. These controls monitor the progress and activities of the organisation and take corrective actions when required. They serve the internal objectives of the organisation and its internal stakeholders, including employees, managers and directors.

These objectives include efficient operations, clear reporting lines, performance measurement and incentive systems. Internal mechanisms include oversight of management, internal audits, structure of the board of directors into levels of responsibility, segregation of control and policy development.

2.2.2 External mechanisms

External control mechanisms are controlled by those outside an organisation and serve the objectives of entities such as regulators, governments and financial institutions.

These objectives include debt management and legal compliance and are often imposed by external stakeholders in the form of regulatory guidelines. External organisations, such as industry or professional associations, may suggest guidelines for best practice.

2.2.3 Audit

An independent external audit of an organisation's financial statements is part of the overall corporate governance structure. An audit of the company's financial statements serves both internal and external stakeholders. A set of audited financial statements and the accompanying auditor's report helps investors, employees, shareholders and regulators determine the financial performance of the organisation.

2.3 Weaknesses with boards

Boards that have failed to manage companies effectively have been a very significant aspect of governance scandals. Different scandals have highlighted certain key weaknesses.

2.3.1 Domination by a single individual

A feature of many corporate governance scandals has been boards dominated by a single senior executive, with other board members merely acting as a rubber stamp. Sometimes, the single individual may bypass the board to action his own interests.

Even if an organisation is not dominated by a single individual, there may be other weaknesses. The organisation may be run by a small group centred round the chief executive and chief financial officer, and appointments may be made by personal recommendation, rather than a formal, objective process.

2.3.2 Lack of involvement of board

Boards that meet irregularly or fail to consider systematically the organisation's activities and risks are clearly weak. Sometimes, the failure to carry out proper oversight is due to a lack of information being provided, or the directors lacking the knowledge or skills necessary to contribute effectively. A board of directors may delegate some aspects of decision-making to executive management, when the decisions should more appropriately be taken by the board.

2.3.3 Lack of supervision

Employees who are not properly supervised by the board can create large losses for the organisation through their own incompetence, negligence or fraudulent activity.

A board of directors does not have direct responsibility for supervision and other internal controls, but the board is responsible for ensuring that the system of internal control is effective.

Professional skills focus: Applying judgement

One of the skills tested in the ACA exams is your ability to apply judgement and critical thinking to a situation. When assessing corporate governance for an organisation, you may be presented with information outlining the structure of the board. Combine your technical knowledge and judgement skills with a review of the relevant exhibits to identify weaknesses in the governance structure and make appropriate recommendations.

2.4 Complaints over directors' remuneration

Complaints over remuneration levels and reward systems for directors and senior executives have been a common feature of corporate governance debates. Complaints have not only focused on remuneration levels, but also on the unwillingness of those who can challenge remuneration packages effectively (non-executive directors, institutional shareholders) to do so. Various problems have been highlighted as follows:

(a) Remuneration levels that are **excessive** per se, and which are not justified by the contribution directors have made

(b) Incentive schemes that do not motivate executives to achieve levels of performance that are in the best long-term interests of shareholders

(c) Remuneration arrangements providing **incentives for directors** to allow risk taking beyond levels that would be deemed acceptable by many shareholders

(d) Directors may be **rewarded for failure**, for example receiving bonuses when their companies have performed poorly and receiving significant compensation payments when they lose office

2.5 Accounts and audit failings

Inevitably, many companies involved in scandals have had glaring weaknesses in internal control – weaknesses that have not been picked up by those monitoring the internal control system.

2.5.1 Lack of adequate control function

Poor governance is often the result of ineffective internal control, and weaknesses in financial (reporting) controls, operational controls and compliance controls within a company. One control weakness may be a lack of an internal audit function. Another important control is lack of adequate technical knowledge in key roles; for example, in the audit committee or in senior compliance positions. A rapid turnover of staff involved in accounting or control may suggest inadequate resourcing, and will make control more difficult because of lack of continuity.

2.5.2 Lack of independent scrutiny

External auditors may not carry out the necessary questioning of senior management because of fears of losing the audit. Often corporate collapses are followed by criticisms of external auditors. For example, the inquiry carried out by the Work and Pensions Committee and the Business, Energy and Industrial Strategy (BEIS) Committee into the collapse of Carillion in early 2018 said that internal and external checks designed to prevent failures of the board had all failed – including those relating to the audit. The report argued that the auditor had failed to exercise professional scepticism towards Carillion's accounting judgements, and failed to paint a true picture of the company's financial problems.

2.5.3 Misleading accounts and information

Often misleading figures are symptomatic of other problems but clearly, poor-quality accounting information is a major problem if markets are trying to make a fair assessment of a company's value.

The ultimate risk from misleading financial reporting is that the company may become insolvent unexpectedly.

Context example: Context example: Patisserie Valerie

ICAEW's *Economia* magazine reports that, in the run-up to the collapse of the coffee and cakes chain Patisserie Valerie, the company's chairman 'felt confident that the numbers were proving the resilience of the business, even though competition, conditions and costs in the hospitality industry were getting tougher.'

He said, 'I received solid weekly numbers, comprehensive monthly management accounts, and… annual accounts that were given a clean bill of health by our auditors.'

However, in October 2018, the CEO informed the Chairman that the company's bank accounts had been frozen, and what they thought had been £28.8m of cash in the bank was in fact nearly £10m of debt, with £9.7m drawn down on two secret bank overdrafts.

In January 2019, Patisserie Valerie crashed into administration, as a result of a widespread accounting fraud, which left the company without sufficient funding to meet its liabilities as they fell due.

Economia (10 June 2019) *Ex Patisserie Valerie chair shocked by Grant Thornton* [Online] Available from: https://economia.icaew.com/news/june-2019/ex-patisserie-valerie-chair-shocked-by-grant-thornton [Accessed 9 July 2019]

2.6 Perspectives on governance

There are several different perspectives on corporate governance, which affect opinions about the relationship between a board of directors and the company's shareholders and other stakeholders.

2.6.1 Stewardship theory

Stewardship theory is based on the view that the directors and management of a company are the **stewards of the company's assets**, charged with the deployment and protection of the assets in ways that are consistent with the overall strategy of the organisation. Shareholders should have the right to dismiss their stewards if they are dissatisfied with their stewardship, by means of a vote at an annual general meeting.

2.6.2 Agency theory

Agency theory is based on the view that the directors of a company act as agents for the shareholders, and have a responsibility to act as agents towards their principals. Unfortunately, there is a risk that the agents will act in their own self-interest rather than in the best interests of the shareholders, and good governance requires measures to prevent this from happening.

Controls over self-interested activities by the company's agents include the requirement for accountability (through financial reporting, other reports, the AGM and so on). In addition, the directors and senior management should be given incentives to act in the best interests of the shareholders, and this can be achieved by means of well-structured remuneration and incentive schemes.

2.6.3 Shareholder theory, enlightened shareholder theory and stakeholder theory

There are different views about the approach that the directors of a company should take towards acting in the interests of shareholders and other stakeholders.

At one extreme is the view that the board of directors should always act in the best interests of the shareholders. The interests and objectives of other stakeholders in the company (such as employees, customers, suppliers and lenders) are of no concern, except to the extent that the best interests of the shareholders are protected.

Towards another extreme is the stakeholder approach to governance. This is based on the view that the directors of a company should act in the interests of all the major stakeholders in their company, not just the shareholders. This will involve making compromises between the conflicting interests of different stakeholder groups. However, the concerns of stakeholders such as employees are as important as those of shareholders.

An approach to governance that lies somewhere between these two extremes is the enlightened shareholder approach. This is based on the view that a board of directors is required primarily to act in the interests of its shareholders, but it should also make compromises and take into consideration the concerns and objectives of other stakeholder groups.

None of these approaches to governance is necessarily 'right' or 'wrong', but they can affect opinions about how corporate governance should be conducted.

3 Stakeholders

Section overview

- Directors and managers should be aware of the interests of stakeholders in governance.
- Major shareholders in companies, especially institutional investors, should recognise their responsibilities for standards of corporate governance, through communications with the company and the exercise of rights (particularly voting rights).

This section focuses on the interests and claims of stakeholders in the context of corporate governance.

The Organisation for Economic Co-operation and Development (OECD) principles of corporate governance recognise that the rights of stakeholders should be respected and protected. Similarly, the UK Corporate Governance Code notes that in order for a company to meet its responsibilities to its stakeholders, the board needs to 'ensure effective engagement with, and encourage participation from, these parties'.

Stakeholders can be internal, within the company (such as the directors and employees) or external to the company (such as most shareholders in a public company, lenders, customers, suppliers, regulators, pressure groups, and the general public).

Professional skills focus: Assimilating and using information

In order to assess corporate governance for an entity you should review and understand the interests of each stakeholder group presented in the scenario. You will need to prioritise key issues and stakeholders from the information provided.

4.1 Directors

The powers of directors to run the company are set out in the company's constitution or articles.

Within a single tier board structure, **executive directors** combine their role as a director with executive management responsibilities, but **non-executive directors** act solely in the capacity of a director.

Under company law in most jurisdictions, the legal duties of directors and responsibility for performance, controls, compliance and behaviour apply to both executive and non-executive directors.

Executive directors often have a conflict of interests, in matters such as remuneration, risk management and internal control, and financial reporting. Independent non-executive directors should act as a counterbalance to executive directors, and should help to ensure that conflicts of interest are avoided (or minimised).

It is important to recognise that executive directors in a company serve two functions: one as directors of the company and the other as executives in the management team.

4.2 Company secretary

In the UK, all public companies must have a company secretary. The company secretary is an important figure in ensuring compliance with legal and other regulatory frameworks, including the governance code. The most important governance duties are generally in the following areas:

(a) Arranging meetings of shareholders and the board of directors.

(b) Providing advice and information to members of the board on legislative, regulatory and governance issues. Under companies' legislation, the secretary (as an officer of the company) is held responsible for numerous breaches of law. Directors' priorities and areas of expertise may not be in the areas of governance and compliance.

(c) Assisting the chairman with the implementation of some governance practices, such as the induction of new directors and performance reviews of the board, its committees and individual directors.

(d) Providing information to board directors and acting as a communication link between the main board and the board committees.

(e) Providing administrative support to the board and its committees.

4.3 Executive management

The interests of senior managers below board level are similar to those of the executive directors in many respects, and there is a risk that these senior executives will seek to promote their personal interests even if these are in conflict with those of the shareholders and other stakeholders.

Although management below board level does not have ultimate responsibility for decision-making within a company, their role in corporate governance is vital. The management team will be responsible for:

- helping to set the tone and ethical character of the company
- supervising the implementation of control and risk management procedures
- providing information that directors need to make decisions about strategy, risk management and control

Senior executives should also be accountable to the board for their performance, usually through the chief executive officer.

4.4 Employees

Other employees need to comply with the corporate governance systems that are in place.

Employees' contribution to corporate governance is to implement risk management and control procedures. If enforcement measures are lax or employees do not have the skills or knowledge necessary to implement procedures, governance will be undermined.

Employees also have a role in giving regular feedback to management and of whistleblowing serious concerns. OECD principles of corporate governance recommend that performance-enhancing mechanisms for employee participation should be permitted to develop.

As stakeholders in their company, employees have an interest in the company's objectives and performance, including the way that the company treats them, in terms of pay and working conditions.

4.4.1 Workforce engagement

The UK Corporate Governance Code emphasises the importance of companies understanding the views of key stakeholders and considering them in the company's decision-making. In order to understand stakeholders' views, it is important company boards engage with stakeholders effectively.

A company's workforce is likely to play a key role in its on-going success, and therefore it is important that directors engage with staff: not only to listen to their issues and concerns, but also to benefit from suggestions and ideas they may have.

The Code also suggests that, in order to facilitate engagement with the workforce, companies use one, or a combination of, the following:

- A director appointed from the workforce, to give the workforce a 'voice' in the boardroom
- A formal workforce advisory panel
- A designated non-executive director (who spends more time in the business, getting an insight into the concerns of employees across the business).

4.5 External auditors

The external audit is one of the most important corporate governance procedures. It enables investors to have much greater confidence in the information that their agents, the directors/managers, are supplying. As well as giving assurance that the accounts give a true and fair view, external auditors can provide other audit services, such as social and environmental audits, and can also highlight governance and reporting issues of concern to investors.

External auditors are employed to scrutinise the activities of managers, who are the shareholders' agents. Their audit fees can be seen as an agency cost. This means that external auditors are also the shareholders' agents. A balance is thus required between working constructively with company management and, at the same time, serving the interests of shareholders.

The external auditors must develop a relationship with both the management of the company and also the audit committee, which has responsibility for oversight of the conduct of the audit.

4.6 Regulators

Definition

Regulation: Any form of interference with the operation of the free market. This could involve regulating demand, supply, price, profit, quantity, quality, entry, exit, information, technology, or any other aspect of production and consumption in the market.

Regulators can be important stakeholders in a company. The major regulators vary between different industries, and include government bodies, such as health and safety executives, and specific regulators such as the financial services authorities, utility regulators and charity commissioners, among many others relevant to specific types of industry.

The interest of regulators in companies is to ensure that companies comply with legal and regulatory requirements, and to take action against those that do not.

4.6.1 Methods of regulation

Legislators and regulators establish **rules and standards** that provide the impetus for management to ensure that risk management and control systems meet minimum requirements. They also **conduct inspections and audits** that provide useful information and recommendations regarding possible improvements. Regulators will be particularly interested in maintaining shareholder-stakeholder confidence in the information with which they are being provided.

Context example: Context example: Reasons for regulation

Regulations are imposed to:

- maintain consumer confidence in the financial system
- assure that a supplier on whom consumers rely (eg, of a major utility) does not fail
- protect consumers from fraud and misrepresentation
- prevent invidious discrimination against individuals
- assure that consumers receive sufficient information to make 'good' decisions, and are dealt with fairly
- assure fair pricing of financial services

Misconduct scandals cost Britain's banks and building societies almost £53 billion in fines and other penalties between 2000–2016. The mis-selling of payment protection insurance was, by far, the largest single factor in this, costing £37.3 billion, more than four times the cost of staging the 2012 London Olympics.

The founder of the think tank New City Agenda, which researched the figures, said: 'The profitability of UK retail banks has been imperilled by persistent misconduct and an aggressive sales based culture' and also that shareholders 'should be leading the campaign to change bank culture and raise professional standards' and 'demand significant clawback of bonuses HYPERLINK "http://www.ft.com/indepth/bank-bonuses" \o "Bank bonuses in-depth from FT.com" significant clawback of bonuses' from accountable managers.

Source: 'Ten biggest bank scandals have cost £53bn in fines'. *Financial Times*, April 11 2016. Available at: www.ft.com [Accessed 28 July 2016]

4.6.2 Regulation and corporate governance

Regulation is important for corporate governance because companies should have an effective internal control system to ensure compliance with key regulatory requirements. All major banks, for example, have very large compliance departments.

In addition, there are some regulations that apply to the conduct of corporate governance. These include criminal laws that apply to activities such as money laundering, insider dealing and bribery; statutory duties of directors; some of the listing rules and disclosure and transparency rules that are applied to listed companies by stock market regulators; and requirements for listed companies to comply with the provisions of a corporate governance code (such as the UK Corporate Governance Code) or explain any non-compliance in their annual report: the 'comply or explain' approach being an aspect of corporate governance in the UK which has been widely copied.

4.7 Government

Most governments do not have a direct economic/financial interest in companies (except for those in which they hold shares). However, governments often have a strong indirect interest in companies' affairs, and therefore in the way they are run and the information that is provided about them:

(a) Governments raise **taxes** on sales and profits and on shareholders' dividends. They also expect companies to act as tax collectors for income tax and sales tax. The tax structure might influence investors' preferences for either dividends or capital growth. Economic policies such as deregulation may be influenced by the desire for economic growth and increased efficiency.

(b) Governments pass and enforce laws as well as establish and determine the **overall regulatory and control climate** in a country. This involves exertion of fiscal pressure, and other methods of State intervention. Governments also determine whether the regulatory framework is **principles or rules based** (discussed later in the Study Manual).

(c) Governments may **provide funds** towards the cost of some investment projects. They may also encourage private investment by offering tax incentives.

(d) In the UK, the Government has made some attempts to encourage more private individuals to become company shareholders, by means of:
   - Attractive **privatisation** issues (such as in the electricity, gas and telecommunications industries)
   - **Tax incentives**, such as Individual Savings Accounts (ISAs), to encourage individuals to invest in shares

4.8 Stock exchanges

Stock exchanges provide a means for companies to **raise money** and for investors to **transfer their shares** easily. They also provide information about company value, derived from the supply of, and demand for, the shares that they trade. Stock exchanges and other financial market organisations list companies whose shares can be held by the general public (called public companies in many jurisdictions). Many such companies have a clear separation between ownership and management, although in some countries even large listed companies may have a large shareholder who also acts as board chairman and/or chief executive officer.

Stock markets and their regulators are important because they provide **regulatory frameworks** in principles-based jurisdictions. In most countries, listing rules apply to companies whose shares are listed on the stock exchange. Stock market regulation can therefore have a significant impact on the way corporate governance is implemented and companies report. The UK is a good example of this, with the 'comply or explain' approach being consistent with the tendency toward self-regulation adopted by many London institutions. In the US, by contrast, a more legalistic and rules-based approach has been adopted, in line with the regulatory approach that is already in place.

4.9 Institutional investors

Institutional investors have large amounts of money to invest. They are covered by fewer protective regulations, on the grounds that they are knowledgeable and able to protect themselves. They include investors managing funds invested by individuals and agents employed on the investors' behalf.

Institutional investors are now the biggest investors in many stock markets but they might also invest venture capital, or lend directly to companies. UK trends show that institutional investors can wield great powers over the companies in which they invest.

The major institutional investors in the UK are:

- Pension funds
- Insurance companies
- Investment and unit trusts (set up to invest in portfolios of shares)
- Venture capital organisations(investors particularly interested in companies that are seeking to expand)

Their funds will be managed by a fund manager who aims to benefit investors in the funds or pension or policy holders.

4.9.1 Advantages and disadvantages of institutional investment

In some respects, the **institutional investor** fulfils a desirable role. People should ideally be in pensionable employment or have personal pension plans. The funds from which their pensions will be payable should be held separately from the companies by whom they are employed. Similarly, investors should have the opportunity to invest through the medium of insurance companies, unit trusts and investment trusts.

However, the dominance of the equity markets by institutional investors has possibly undesirable consequences as well.

(a) **Excessive market influence**

For capital markets to be truly competitive, there should be no investors who are of such size that they can influence prices. In the UK, transactions by the largest institutions are now on such a massive scale that considerable price movements can result.

(b) **Playing safe**

Many institutions tend to avoid shares which are seen as speculative, as they feel that they have a duty to their 'customers' to invest only in 'blue chip' shares (ie, those of leading commercially sound companies). As a result, the shares of such companies tend to be relatively expensive.

(c) **Short-term speculation**

Fund managers are sometimes accused of 'short-termism' in that they will tend to seek short-term speculative gains or simply sell their shares and invest elsewhere if they feel that there are management shortcomings.

(d) **Lack of power of investors**

Investors in investment and pension funds cannot directly influence the policy of the companies in which their funds invest, since they do not hold shares themselves and cannot hold the company accountable at general meetings.

4.9.2 Role of institutional investors

UK guidance has placed significant emphasis on the role of institutional investors in promoting good corporate governance.

The UK Corporate Governance Code states that, in line with their responsibilities under the UK Stewardship Code, investors should engage constructively with companies, and discuss with them any departures from recommended practice.

4.9.3 UK Stewardship Code

Effective corporate governance calls for effort on the part of shareholders as well as boards of directors.

In the UK, institutional investors are encouraged to state their commitment to a Stewardship Code, first published in 2010 and most recently updated in 2020. This Code contains a number of principles that institutional investors and their advisors should apply as shareholders in listed companies, explaining how they are appropriate to their own specific context. The Stewardship Code states that asset owners and asset managers (ie shareholders) should consider the following:

(a) Purpose and governance - this includes promoting a culture of long term value creation which benefits the economy, the environment and society at large, recognising that various ethical threats and other risks may present obstacles

(b) Investment approach - embracing transparency and accountability within a framework that recognises the importance of environmental, social and ethical matters as well as the impact of climate change

(c) Engagement - working collaboratively to achieve investment objectives, including protocols for escalating relevant issues

(d) Exercising rights and responsibilities - actively fulfilling these rights and responsibilities

4.9.4 Means of exercising institutional investors' influence

A number of different methods may be effective.

In addition to the guidance for shareholders, there is also guidance for service providers who support them (such as consultants or analysts):

(a) **One to one meetings**

These discuss strategy, whether objectives are being achieved, how the company is achieving its objectives and the quality of management.

(b) **Voting**

Most corporate governance reports emphasise the importance of institutional investors exercising their votes regularly and responsibly. If they are intending to oppose a resolution, they should normally state their intention in advance.

(c) **Focus list**

This means putting companies' names on a list of underperforming companies. Such companies' boards may face challenges.

(d) **Contributing to corporate governance rating systems**

These measure key corporate governance performance indicators, such as the number of non-executive directors, the role of the board and the transparency of the company.

4.9.5 Intervention by institutional investors

In extreme circumstances, the institutional shareholders may intervene more actively by, for example, calling a company meeting in an attempt to unseat the board. Reasons why institutional investors might intervene include:

- Fundamental concerns about the strategy being pursued in terms of products, markets and investments
- Poor operational performance, particularly if one or more key segments has persistently underperformed
- Management being dominated by a small group of executive directors, with the non-executive directors failing to hold management to account
- Major failures in internal controls, particularly in sensitive areas such as health and safety, pollution or quality
- Failure to comply with laws and regulations or governance codes
- Excessive levels of directors' remuneration
- Poor attitudes towards corporate social responsibility

Context example: Context example: Shareholder activism

In July 2018, 70% of Royal Mail plc shareholders voted against the pay packages of senior executives, including new boss Rico Back. Ahead of the AGM, investor advisory firms ISS and Glass Lewis had urged shareholders to vote against the remuneration packages, criticising Royal Mail's decision to pay a higher salary to newly appointed chief executive Back than was paid to his predecessor Moya Greene. They also criticised Greene's £900,000 pay-off.

ISS said in a document: "Support for the remuneration report is not considered warranted due to termination payments to the former CEO which exceed UK market norms and also include an element of guaranteed bonus payments. The company's treatment of the former CEO's bonus is not considered to be on a cost-neutral basis for shareholders and the disclosures in previous years have fallen short of accurate representation on termination provisions that have now fallen due. Finally, the newly appointed CEO's salary is at a level higher than that of the outgoing CEO."

Source:http://www.proactiveinvestors.co.uk/companies/news/201156/royal-mail-shareholders-vote-against-pay-package-for-new-boss-rico-back-201156.html [Accessed 7 August 2018]

4.9.6 Stakeholder activism and the internet

Stakeholder activism in the era of the internet is powerful and widespread, with a significant increase over the last decade in the number of environmental and social activists. These groups can coordinate their activities using websites, email and mobile communications. This has put even more pressure on the expectations of corporate governance mechanisms, especially in the area of risk management.

4.10 Small investors

Small investors may not have the same ease of access to information that institutional investors possess, or the level of understanding of experts employed by institutional investors. Their portfolios are likely to be narrower and they may be less able to diversify risk away.

The OECD suggests that a key principle of corporate governance is that all shareholders should be treated **equally**. For example, in a takeover, minority shareholders should receive the same consideration and treatment as larger shareholders.

The OECD guidelines also stress the importance of achieving shareholder protection by enforcing the **basic rights of shareholders**. These include the right to secure methods of ownership registration, convey or transfer shares, obtain relevant and material information, participate and vote in general meetings and share in the profits of the company. Under the OECD guidelines, shareholders should also have the right to participate in, and be sufficiently informed on, decisions concerning fundamental changes, such as amendments to the company's constitution.

5 Role of boards

Section overview

- The effectiveness of the board as a mechanism for governance depends on the composition and balance of the board, the steps the board takes to maintain and improve its effectiveness and the roles played by the chairman as board leader, and by the non-executive directors and board committees.
- The most important areas in which the board must operate effectively are strategy setting, risk management and performance monitoring.

6.1 Role of board

The South African King Report (updated in November 2016) provides a good summary of the role of the board:

"To define the purpose of the company and the values by which the company will perform its daily existence and to identify the stakeholders relevant to the business of the company. The board must then develop a strategy combining all three factors and ensure management implements that strategy."

The Principles of the UK Corporate Governance Code also identify the role of the board:

- To provide effective and entrepreneurial leadership for the company, and to promote its long-term, sustainable success, generating value for shareholders and contributing to wider society. [Principle A]
- To establish the company's purpose, value and strategy, and to satisfy itself that these are aligned with the company's culture. [Principle B]

- To ensure that the necessary resources are in place for the company to meet its objectives, and to measure performance against them. The board should also establish a framework of prudent and effective controls which enable risk to be assessed and managed. [Principle C]

Context example: Context example: Enron

One of the most significant scandals in the US in the last 20years was the collapse of Enron, an energy company that by 2000 had grown into one of the world's largest corporations. Although investors were unaware at the time, the growth in Enron was attributable largely to misleading and questionable accounting practices. The company inflated the reported value of its assets (sometimes recording expenses as assets) and kept liabilities off its balance sheet by means of using special purpose entities. It also inflated reported profits by becoming the first non-financial company to use mark-to-market accounting methods, which enabled it to book profits 'up front' at the beginning of long-term contracts.

Senior management were motivated to continue reporting annual profits growth by the incentives in their remuneration scheme. Concerns about Enron's accounts began to emerge. A 'whistle blower' reported her concerns to the company CEO, but these were ignored. In October 2001, however, Enron eventually had to announce that it would be restating its profits for the previous four years to correct accounting violations. After the SEC announced an investigation into Enron's affairs, the stock price collapsed and the company's bonds were downgraded to junk bond status. The company filed for bankruptcy in December 2001.

The company's auditors were Arthur Andersen (AA), which was then one of the 'Big Five' global accountancy firms. The Houston office of AA took extraordinary measures to protect its client (whose head office was in Houston). AA attempted to cover up evidence of negligence in its audit work by destroying several tons of documents and large numbers of emails and computer files. Although a conviction for obstructing the court of justice was eventually overturned by the US Supreme Court, it was too late to save AA from loss of major clients and collapse.

Several senior executives of Enron were brought to trial and convicted of a number of financial crimes, including fraud, insider dealing, money laundering and conspiracy.

Enquiries into the scandal exposed a number of weaknesses in the company's governance. The company's management team was criticised for being arrogant and overambitious. The non-executive directors were weak, and there were conflicts of interest. The chair of the audit committee was Wendy Gramm. Her husband, Senator Phil Gramm, received substantial political donations from Enron.

6.2 Set-up of board

Worldwide there are a variety of governance models, based on different ways of formalising the distinction between those who manage a company (the executives) and those who monitor these managers (the directors).Where some executive managers are also company directors, arrangements should be in place for the monitoring of the executive directors by their non-executive colleagues.

6.2.1 Unitary boards – UK and US

The UK model of corporate governance is based on the idea of a unitary board, consisting of a mix of executive and non-executive directors. All directors **participate in board decision-making**. All participants in the single board have **legal responsibility** for management of the company and strategic performance.

The US model is also based on a unitary board structure, although the proportion of non-executives on US boards may be higher than in UK companies.

6.2.2 Multi-tier boards– Germany

Institutional arrangements in German companies are based on a **dual board**(two-tier structure).

(a) **Supervisory board**

A **supervisory board** of non-executives includes workers' representatives and stakeholders' representatives, including banks' representatives. The supervisory board has no executive function, although it does review the company's direction and strategy and is responsible for **safeguarding stakeholders' interests**. It must receive formal reports of the state of the company's affairs and finance. It approves the accounts and may appoint committees and undertake investigations. The board should be composed of members who, as a whole, have the required **knowledge, abilities and expert experience** to complete their tasks properly and are sufficiently independent.

(b) **Management board**

A **management or executive board**, composed entirely of managers, will be responsible for the day to day **running** of the business. The supervisory board appoints the management board. Membership of the two boards is entirely separate.

6.3 Board effectiveness

The UK Financial Reporting Council (FRC) published a Guidance on Board Effectiveness in 2018, to accompany the updated Corporate Governance. The Guidance on Board Effectiveness stresses that an effective board' defines the company's purpose and then sets a strategy to deliver it, underpinned by the values and behaviours that shape its culture and the way it conducts its business'.

An effective board will also be able to explain the main trends and factors affecting the company's long-term success (eg, technological change) and how these and the company's principal risks and uncertainties have been addressed.

One of the important characteristics of an effective board is that it makes well-informed, and high quality decisions. Factors that contribute to this include:

- Robust debate in the boardroom, reflecting the diversity of skills and perspectives of the directors and avoiding 'group think'
- Allowing sufficient time for debate and discussion of all issues within the board's remit
- Obtaining input from key stakeholders
- Obtaining expert opinions when necessary

The FRC guidance (2018) also stresses that boards need to be aware of factors that can limit effective decision-making (and to try to avoid them):

- A dominant personality or group of directors on the board, inhibiting contribution from others
- Insufficient diversity of perspective on the board, contributing to 'group think'
- Excess focus on risk mitigation, or insufficient attention to risk
- Treating risk as a compliance issue, rather than as part of the decision-making process
- Insufficient knowledge and ability to test underlying assumptions
- Failure to listen to, and act upon, concerns that are raised
- Failing to recognise the consequences of running the business on the basis of self-interest and other poor ethical standards
- A lack of openness by management, reluctance to involve non-executive directors, or a tendency to bring matters to the board for sign-off, rather than debate
- Complacent or intransigent attitudes
- Inadequate information or analysis; poor quality board papers
- Lack of time for debate, and truncated debate
- Undue focus on short-term time horizons (rather than longer-term issues)

6.3.1 Board size

A board should be neither too large nor too small. A large board provides more opportunities for **varied views** to be put forward, and with a large board it is easier to divide responsibilities (such as membership of board committees) and to deal with personnel changes when they occur. However, a large board can make it difficult to reach quick decisions when these are needed and to achieve consensus in decision-making.

A complex company operating in a complicated environment may need a bigger board to have access to a wide range of skills and experience. On the other hand, a company operating in a fastmoving environment where rapid decision-making is required may be better served by a smaller board.

6.3.2 Board composition

In order to carry out their roles effectively, directors collectively need to have **relevant expertise** in the industry, the company's affairs, key functional areas and governance.

The UK Corporate Governance Code states that 'the board and its committees should have a combination of skills, experience and knowledge.'

No individual, or small group of individuals, should be allowed to dominate decision-making by the board. An important way of ensuring this is by having an appropriate combination of executive and non-executive (and, in particular, independent non-executive) directors on the board. The UK Corporate Governance Code states that 'at least half the board, excluding the chair, should be non-executive directors whom the board considers to be independent.'

Context example: Context example: Board composition grid

Guidance, published by PwC and the Institute of Internal Auditors Research Foundation, highlights the use of a grid to help a board analyse what skills and experience it needs. The grid lists the skills, experience and attributes required, and which directors possess them, and decides whether there are any areas in which the board is lacking. The example grid given lists the following:

- Financial literacy
- Financial expertise
- Industry expertise
- International expertise
- Operational experience
- Technology expertise
- Governmental/regulatory experience
- Social/environmental expertise
- Marketing expertise
- Gender diversity
- Ethnic diversity

However, the FRC Guidance on Board effectiveness highlights that in addition to 'technical' skills and experience, it is also important to consider directors' personal attributes to ensure they display a range of 'softer skills'; for example, openness, honesty, the ability to forge relationships, and the ability to develop trust.

6.3.3 Diversity

The UK Corporate Governance Code states that 'appointments to the board should be subject to a formal, rigorous and transparent procedure.' The Code also highlights that appointments 'should be based on merit and objective criteria [ie, avoiding discrimination] and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths.'

Diversity can have a positive effect on the quality of decision-making by directors, by reducing the risk of group think. Directors will be more likely to make good decisions and maximise the opportunities for the company's success if the right skillsets and an appropriate breadth of perspectives are present in the boardroom.

Context example: Real life example: Board composition and diversity

Britain's most successful companies tend to have a large proportion of women in senior management roles, but the UK lags behind the US and Australia on board diversity.

A 2018 report by McKinsey highlighted that the proportion of women on FTSE boards has grown since 2011, but while women now make up around a third of non-executive directors, their representation among senior management teams is much lower.

UK firms are well above the global average, with around 15% of executive roles held by women, but in the US that figure is 19%, and in Australia it is 21%. In 2018 (at the time of the report) only seven FTSE 100 companies had women chief executives.

From April 2018, all UK companies with at least 250 staff have to publish the gap between what they pay men and women.

Source: https://www.telegraph.co.uk/business/2018/01/19/britains-successful-companies-have-women-senior-roles/ [Accessed 7 August 2018]

6.3.4 Independence

Definition

Independence:

(a) There should be a clear set of governance principles for anyone working in this capacity, addressing issues such as culture, incentives and ethics and how they promote effective stewardship

(b) Anyone signing up to these principles should respond appropriately to the risks presented by the market including those of an environmental, social and governance nature

The avoidance of being unduly influenced by vested interests and being free from any constraints that would prevent a correct course of action being taken. It is an ability to stand apart from inappropriate influences and be free of managerial capture, to be able to make the correct and uncontaminated decision on a given issue.

There are two aspects to independence of board directors.

(a) Independence, in particular freedom from conflict of interests and a willingness to consider issues objectively and in the best interests of their company, is important for all directors. All directors should be independent-minded.

(b) However, there is a risk that executive directors, and non-executives with a long association with the company, may find it difficult to be entirely independent. They may be inclined to side with executive management on certain matters, such as budgets and investments. In some areas of governance, such as executive remuneration, executive directors have a clear conflict of interests. It is therefore considered good governance practice for a certain number of board directors to be both non-executives and also clearly independent from the company. These are 'officially' recognised by the company as **independent non-executive directors (NEDs)**.

Independent NEDs should play a key role in challenging the views of their executive colleagues.

It is generally recognised that the independence of NEDs will tend to erode over time as they become more familiar with the company. The UK Corporate Governance Code therefore includes a provision that if a director has served on a board for more than nine years this is likely to impair, or could appear to impair, a NED's independence. If a NED has been on the board for more than nine years, but is still considered to be independent, a clear explanation should be provided as to why this is the case.

6.3.5 Matters reserved for decision-making by the board

Most codes emphasise that the board should have a **formal schedule of matters** specifically reserved to it for decision at board meetings.

Some decisions should clearly be taken by the board, such as decisions to approve the financial statements and annual report; decisions about dividends; and decisions about inviting new members to join the board.

The board should also approve the annual budget and the company's overall strategic objectives. It should monitor the company's performance, and require management to present regular budgetary control reports for review and questioning by the board.

The board should normally expect to make decisions about:

- major acquisitions
- major investments
- borrowing decisions (such as bond issues and share issues)
- the company's appetite for strategic and financial risk
- the use of financial derivatives

Context example: Context example: Board agenda

The Code of Corporate Governance for Bangladesh provides a fuller list than many other codes, identifying the range of matters a board must consider. This list partly reflects local concerns:

- Annual operating plans and budgets, together with updated long-term plans
- Capital budgets, manpower and overhead budgets
- Quarterly results for the company as a whole and its operating divisions or business segments
- Internal audit reports, including specific, material cases of theft and misconduct
- Cause, demand and prosecution notices received from revenue authorities
- Fatal or serious accidents and any effluent or pollution problems
- Default in payment of interest or principal on any public deposit, secured creditor or financial institution
- Any possible public or product liability which is material and estimable
- Details of any joint venture or collaboration agreement
- Recruitment and remuneration of senior officers just below board level, including appointment or removal of the company secretary and most senior financial officers
- Any labour issues and their proposed resolution

6.3.6 Board performance appraisal

Appraisal of the board's performance and effectiveness is an important control, aimed at **improving board effectiveness, maximising strengths and tackling weaknesses**. The UK Corporate Governance Code recommends that **performance of the board, its committees, the chair and individual directors** should be formally **assessed annually**. The Code also suggests that the chair should consider having a regular, externally facilitated board evaluation.

Board evaluation can bring benefits from improved performance by the board, its committees and individual board members by recognising their strengths and identifying any weaknesses and acting to deal with them.

An annual performance review can also help the chairman and nomination committee to plan changes to the composition of the board, by comparing the range of skills and experience that the board and its committees need with the current composition and competences of the board membership.

Context example: Context example: Board effectiveness

An ICAEW website article ('Board evaluations and effectiveness reviews') suggests that subsidiary company boards are often training grounds in listed companies, and encouraging good governance through performance reviews at this subsidiary level can pay dividends at group level later on.

https://www.icaew.com/en/technical/corporate-governance/uk-corporate-governance/board-evaluations-and-effectiveness-reviews

6.4 Chairman and chief executive officer:

The most important point in the leadership of a company is that there are two roles at its head:

- **Chairman** – Leader of the board
- **Chief executive (CEO)** – Leader of the executive management team

6.4.1 Role of CEO

The CEO is responsible for **running the organisation's business** and for **proposing and developing the group's strategy** and **overall commercial objectives**, in consultation with the directors and the board. The CEO shapes the values, principles and major operating policies on which the internal control systems are based. The CEO will examine major investments, capital expenditure, acquisitions and disposals and be responsible for identifying new initiatives. The CEO **manages the risk profile and control systems of the organisation**.

The CEO is also responsible for **implementing the decisions of the board** and its committees, **developing the main policy statements** and **reviewing** the business's **organisational structure and operational performance**.

The CEO is the senior executive in charge of the management team and is answerable to the board for its performance. They will have to formalise the roles and responsibilities of the management team, including determining the degree of delegation.

6.4.2 Division of responsibilities

One of the most controversial areas of corporate governance has been whether the roles of chairman and CEO can be held by the same person.

All governance reports acknowledge the importance of having a division of responsibilities at the head of an organisation to avoid the situation where one individual has **unfettered control** of the decision-making process. This can be achieved by the roles of **chairman** and **CEO** being held by two different people, which has the following advantages.

(a) **Demands of roles**

It reflects the reality that both jobs are **demanding roles** and, ultimately, the idea that no one person would be able to do both jobs well.

(b) **Authority**

The chairman **carries the authority of the board**, whereas the CEO has the authority that is **delegated by the board**. Separating the roles emphasises that the chairman is acting on behalf of the board, whereas the CEO has the authority given in their **terms of appointment**. Having the same person in both roles means that **unfettered power** is concentrated into one pair of hands.

(c) **Conflicts of interest**

The separation of roles avoids the risk of **conflicts of interest**. The chairman can concentrate on representing the interests of shareholders.

(d) **Accountability**

The board cannot make the CEO **truly accountable** for management if it is chaired by the CEO.

(e) **Board opinions**

Separation of the roles means that the board is more able to express its concerns effectively by providing a point of reporting (the chairman) for the NEDs.

(f) **Control over information**

The chairman is responsible for obtaining the information that other directors require to **exercise proper oversight and monitor the organisation effectively**. If the chairman is also CEO, then directors may not be sure that the information they are getting is sufficient and objective enough to support their work.

(g) **Compliance**

Separation enables compliance with governance best practice and hence reassures shareholders.

Context example: Context example: Facebook

In May 2019, Mark Zuckerberg, the founder of Facebook faced a shareholder revolt which wanted to strip him of being chairman of the company, as well as chief executive.

Shareholders voiced concerns that Mr Zuckerberg's dual roles concentrated too much power on a single person, as well as severely limiting the board's ability to control or change things in the company.

The shareholders' motions, presented at the AGM, followed a torrid year for the company, in which it faced a number of scandals from data breaches, fines and election meddling (through the improper selling of data to Cambridge Analytica).

However, Mr Zuckerberg, who controls around 58% of the voting rights at Facebook, was able to vote down the shareholders' proposals.

6.5 Non-executive directors (NEDs)

Definition

Non-executive directors: Directors who have no executive (managerial) responsibilities.

Under the UK unitary board system there is no legal distinction between executive directors and NEDs. NEDs have the same legal duties, responsibilities and potential liabilities as executive directors, even though they are not expected to give the same continuous attention to the company's business.

However, as the UK Corporate Governance Code notes, NEDs have a key role in **scrutinising and holding to account** the performance of management and individual executive directors against their performance objectives.

NEDs on the **remuneration committee** are responsible for deciding the appropriate levels of remuneration for executive directors, while NEDs on the **audit committee** are responsible for monitoring the integrity of a company's financial statements, and reviewing its internal financial controls and internal control and risk management systems.

NEDs also have a prime role in succession planning, and in the appointment and removal of executive directors.

6.5.1 Contribution of NEDs

NEDs can contribute to a board of directors in various ways.

(a) **Experience and knowledge**

They may have **external experience and knowledge which executive directors do not possess.** The experience they bring can be in many different fields. They may be executive directors of other companies and have experience of different ways of approaching corporate governance, internal controls or performance assessment. They may also bring knowledge of markets within which the company operates, the mechanisms of government or financial skills.

(b) **Varied roles**

The English businessman, Sir John Harvey-Jones, pointed out that there are **certain roles** NEDs are well-suited to play. These include 'father-confessor' (being a confidant for the chairman and other directors),'oil-can'(intervening to make the board run more effectively) and acting as 'high sheriff' (if necessary, taking steps to remove the chairman or CEO).

The most important advantage perhaps lies in the dual nature of the NED's role. NEDs are full board members who are expected to have the level of knowledge that full board membership implies.

At the same time, they are meant to provide the so-called strong, independent element on the board. This should imply that they have the knowledge and detachment to be able to monitor the company's strategy and affairs effectively. In particular, they should be able to assess fairly the remuneration of executive directors when serving on the remuneration committee, be able to discuss knowledgeably with auditors the affairs of the company on the audit committee, and be able to scrutinise strategies for excessive risks.

The UK Corporate Governance Code recommends that at least half the members of boards of large listed companies, excluding the chairman, should be independent NEDs.

Interactive question 1: Recruitment of non-executive directors

QP is a major quoted company that manufactures industrial chemicals. The company's board comprises a chief executive and five other executive directors, a non-executive chairman and four non-executive directors.

Two of the non-executive directors have served on QP's board for five years. The company has a policy of asking non-executive directors to stand down after six years and so the chairman has established a nominations committee to start the process of selecting replacements.

Three replacements have been suggested to the nominations committee. The nominees are:

- Adrian, who is on the main board of City Pensions, an investment institution which owns 6% of QP's equity. Adrian has worked for City Pensions for 15 years and has always worked in the management of the company's investments, initially as an analyst and, more recently, as director in charge of investments. Before working for City Pensions, Adrian was an investment analyst with an insurance company for 15 years.
- Nicole, who is an ICAEW member, is about to retire from full-time work. Nicole has had a varied career, including acting as a management accountant with an engineering company and finally as a senior accountant with a commercial bank. Nicole was promoted to the bank's board and has been finance director for seven years.
- Helen, who is a former politician. After a brief career as a journalist, Helen became a member of parliament at the age of 40. After spending 20 years as a politician, including several years as a government minister, Helen has recently retired from politics at the age of 60. Helen already holds two other non-executive directorships in companies that do not compete with, and are not in any way connected to, QP.

Requirement

Evaluate the suitability of each of the three nominees. Your answer should include arguments for and against each of the nominees.

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

6.6 Board committees

Many company boards establish a number of board committees with responsibility for supervising specific aspects of governance. A committee system does not absolve the main board of its responsibilities for the areas covered by the board committees.

For a committee structure to work effectively, there needs to be effective communication and constructive relationships between the committees and the full board.

The committees with governance responsibilities consist entirely or mainly of independent NEDs and some NEDs are therefore likely to be members of more than one board committee.

6.6.1 Nomination committee

The main task of the nomination committee is to recommend new appointments to the board. A very important consideration is whether the current board has the **skills, knowledge and experience** necessary to take sound strategic decisions and to run the company effectively. This must be balanced against wider factors such as the executive–non-executive balance, continuity and succession planning, and size and diversity of the board.

The nomination committee may also take the lead in ensuring that each committee has members with the right skills and experience, and that board members understand their role(s) within the board structure.

The board chairman also has responsibilities for ensuring that the composition of the board meets the requirements of the company, and in the UK it is common in listed companies for the board chairman also to be the chairman of the nomination committee (although the chair of the board must not chair the committee if it is dealing with the appointment of their successor).

6.6.2 Audit committee

The audit committee is responsible for:

(a) liaising with the external auditors and monitoring auditor independence

(b) monitoring the external audit and reviewing the financial statements

(c) monitoring the effectiveness of the internal control system and risk management system

(d) supervising the internal audit function (or if there is no internal audit function, considering each year the need for one)

The audit committee's responsibilities in relation to risk management will depend on whether there is a separate risk committee of the board. This includes confirming that there is a **formal policy** in place for **risk management** and that the policy is backed and regularly monitored by the board. The committee should also **review** the **arrangements**, including training, for ensuring that managers and staff are aware of their responsibilities. Committee members should use their own knowledge of the business to confirm that risk management is updated to **reflect current positions and strategy**.

The UK Corporate Governance Code states that the board of directors should monitor a company's risk management and internal control system, and, at least annually, review their effectiveness and report on this in the annual report.

The audit committee is responsible for assessing the **independence and objectivity** of external audit and the effectiveness of the external audit process. Its roles in this area include:

(a) Being responsible for recommending the **appointment, reappointment or removal of the external auditors**, as well as fixing their remuneration.

(b) Considering whether there are **any other threats to external auditor independence.** In particular, the committee should consider **non-audit services** provided by the external auditors, paying particular attention to whether there may be a **conflict of interest**.

(c) **Discussing the scope of the external audit** prior to the start of the audit. This should include consideration of whether external audit's coverage of all areas and locations of the business is fair, and how much external audit will rely on the work of internal audit.

(d) Acting as a **forum for liaison** between the external auditors, the internal auditors and the finance director.

(e) **Helping the external auditors to obtain the information** they require, and resolving any problems they may encounter.

(f) **Making themselves available** to the external auditors for consultation, with or without the presence of the company's management.

(g) Dealing with any **serious reservations** which the external auditors may express either about the accounts, the records or the quality of the company's management.

Interactive question 2: Audit committee

KPN is a major hotel group that will shortly be seeking a flotation on the stock market in its country. At present, the company does not have any non-executive directors or an audit committee. One of KPN's most significant local competitors, NN, has recently collapsed; some of the competitor's shareholders have raised issues about the ineffectiveness of the non-executive directors and in particular, the failure of the audit committee to deal with major accounting problems. As this news story is topical, the directors of KPN want to understand why NN's non-executive directors might have failed to exercise sufficient supervision, and how the audit committee that KPN will be required to establish can function effectively.

Requirements

2.1 Explain the limitations of depending on non-executive directors to improve corporate governance.

2.2 Explain how the effectiveness of audit committees can be enhanced.

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

6.6.3 Remuneration committee

The remuneration committee is responsible for:

(a) advising the board on executive director remuneration policy; and

(b) negotiating and agreeing the specific remuneration package for each executive director, and usually for senior executives below board level, in accordance with the board's remuneration policy.

The UK Corporate Governance Code highlights that "Remuneration policies and practices should support strategy and promote long-term sustainable success. Executive remuneration should be aligned to company purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy".

Areas of contention about senior executive remuneration may be:

(a) The proportion of remuneration that should be fixed salary and the proportion that should be performance related

(b) The balance between short-term incentives (typically annual bonuses) and long-term incentives (typically share options or grants of shares)

(c) The size of remuneration packages, especially the potential size of performance-related bonuses and share awards, and when the size of executive remuneration is compared to that of 'the average worker' in a company

(d) The extent to which annual bonuses focus on short-term financial performance; alternatively the excessive diversity of multiple performance targets for annual bonuses

(e) Rewards for failure: large payments to directors who are forced to resign

In the UK, quoted companies are now required to submit their remuneration policy to the shareholders for approval at least every three years. The shareholders' vote is binding, and companies are then required to ensure that remuneration packages for executives comply with the policy.

6.6.4 Risk committee

Some listed companies have a risk committee of the board. The risk committee is responsible for **overseeing the organisation's risk management systems**. It is not a compulsory committee under most governance regimes. However, listed companies that are subject to significant financial market risk (such as banks) will usually have a risk committee. To be effective, the committee members collectively will need a high level of expertise in finance and/or risk management.

We shall examine the risk committee's work further in the next chapter.

Professional skills focus: Structuring problems and solutions

In the exam you may be required to suggest how an organisation could improve corporate governance through its use of board committees. It is important to be familiar with the types of committee and their respective roles so you can confidently identify appropriate solutions to corporate governance weaknesses.

6.7 Strategy setting and the board

Boards are responsible for corporate strategy but they can manage strategic development in different ways.

Boards in larger companies usually adopt more of a **stewardship role** – directors approve strategic plans, but strategic management and development and strategy implementation are the responsibility of the executive team. There can be a risk that the board will delegate too much responsibility for strategy to management. Good governance requires that major strategic decisions and overall guidance on risk should be the decision-making responsibility of the board.

Michael Porter has emphasised the importance of a **clear strategic leader** who 'takes ownership' of strategic development and is accountable to the board for its success or failure. The obvious strategic leader is the CEO.

In theory, other executive directors and managers should be able to assist the CEO by providing the benefit of their own experience and knowledge.

6.8 Risk management and the board

6.8.1 Board responsibilities

The board has overall responsibility for the effectiveness of risk management in its company. The UK Corporate Governance Code states that the board is responsible for deciding the **nature** and **extent** of the principal risks a company is willing to take in order to achieve its long-term strategic objectives. They should confirm that they have carried out an assessment of the principal risks facing the company, including those that threaten future performance and solvency, and how such risks can be managed.

In 2009 COSO (the Committee of Sponsoring Organizations of the Treadway Commission in the US) published a paper, *Strengthening Enterprise Risk Management for Strategic Advantage* ,which provides guidance on enhancing the board's risk management capabilities.

(a) **Discuss risk management philosophy and risk appetite**

The board and senior management have to understand the level of risk that they want their company to take, including whether it is consistent with stakeholder expectations. Risk appetite should be a key element in objective setting and strategy selection, and will also determine risk management processes.

The COSO guidance suggests that as a starting point, the board should consider the strategies that they would not be interested in pursuing, due to the **level of risk** involved or the **inadequacy of returns** for the risks incurred. The guidance suggests a series of questions that can be used to help determine risk appetite:

- Do shareholders want us to pursue high risk/high return businesses, or do they prefer a more conservative, predictable business profile?
- What is our desired risk rating?
- What is our desired confidence level for paying dividends?
- How much of our budget can we subject to potential loss?
- How much earnings volatility are we prepared to accept?
- Are there specific risks that we are not prepared to accept?
- What is our willingness to consider growth through acquisitions?
- To what extent are we willing to expand our product, customer or geographical coverage?
- What amount of risk are we willing to accept on new initiatives to achieve a specified target?

(b) **Understand risk management practices**

Boards need to ensure that an awareness of risk and a culture of risk management permeates the organisation, and that risk management practices and procedures are applied by all managers and staff.

(c) **Review portfolio risks in relation to risk appetite**

Boards need to **understand the portfolio of risk exposures** facing their company so that they can determine whether these are consistent with stakeholders' tolerance of risk and the board's appetite for risk.

(d) **Be appraised of the most significant risks and related responses**

Since risks are continuously evolving and changing in character and significance, risk management processes need to ensure that timely and robust information about risks is provided. Board members need to have sufficient experience, training and knowledge of the business to discuss properly the risks that the business faces.

6.8.2 Strategic risks and operating risks

A distinction can be made between strategic risks and operating risks.

(a) **Strategic risks** are risks that come from the environment in which the business operates. These include risks from competition, and risks from changes within the industry and in customer/consumer demand. They also include risks in the broader business environment, such as economic risks, financial market risks, risks from technological change or political or regulatory change.

(b) **Operating risks** are risks of failure in processes and procedures within the company's operating activities. These may be classified as financial reporting risks (risks of errors or failures in accounting systems and financial reports); compliance risks (risks of failure to comply with laws and regulations); and general operational risks (risks of failures due to human error, deliberate fraud, machine and technology failures and failures in procedures and processes).

Context example: Context example: Risk in the cloud

The risks associated with cloud computing have gained prominence in recent years. Sensitive information is passing through third-party cloud providers and organisations face new risk management concerns.

- Who decides what information should be stored and shared in the cloud?
- Who safeguards company data in the cloud and manages the associated risks?

The increase in cloud services has created new responsibilities for IT functions, with internal audit needing to make cloud-related risks a priority in terms of IT risk management, security and privacy. However, while the use of the cloud for data and applications storage can cut IT costs and speed up operations, less than 10% of the world's data is currently stored in the cloud, with data security issues such as those mentioned above being a key concern. Companies need to be happy to hand control of their data to a cloud services provider, who provides the resources for storing the data, but does not necessarily control how it is to be protected from corruption, loss or theft. Common security methods include encryption and two factor authentication.

Source: 'Can we trust cloud providers to keep our data safe?' *BBC*, 29 April 2016. Available at: www.bbc.co.uk [Accessed 28 July 2016]

Strategic risks should be recognised and monitored within the strategic management process. Operating risks should be controlled by an effective internal control system.

The board is responsible for ensuring that there are effective systems for risk management and internal control. The implementation of controls, including the design of internal controls, is the responsibility of management. The board is responsible for review of effectiveness, and should seek assurance that risk management and internal control systems remain effective, and ensure that measures are taken by management to rectify any weaknesses that are identified.

Professional skills focus: Concluding, recommending and communicating

All businesses are subject to risk and, whilst risk cannot be completely eliminated, suitable mitigating actions and controls can be put in place. As a professional accountant it is important to be able to identify strategic and operating risks and to make suitable recommendations to manage them.

6.8.3 Review of risk

The board should review on a **regular basis**:

(a) The nature of the risks facing the company and its business, and the systems for identifying and recording risks

(b) The processes for risk assessment –the potential scale of the risk and the probability that adverse risk events will occur

(c) The measures that are in place for managing risks –to keep business strategy within tolerable risk limits, to reduce the likelihood that risk events or operating failures will occur, to insure against adverse risk events or to avoid risks

(d) The systems and procedures that are in place for the regular review/monitoring of risk and risk management by the executive management team

(e) The costs of operating particular controls, compared to their benefits

The board should focus on serious risks, whether they are long term or short term; and strategic or operational.

Boards should review risks and internal control as a regular part of their agenda. As we have already mentioned, the UK Corporate Governance Code, for example, states that the board should review the effectiveness of the risk management and internal control systems at least annually.

A key aspect for the directors to consider is the **frequency of monitoring of risks by management**. Some risks may need to be monitored daily (for example, foreign exchange risks in a global company); others much less frequently.

Ineffective monitoring increases the likelihood of control breakdowns, which could materially impact an organisation's ability to achieve its objectives. **Inefficient** monitoring leads to a lack of focus on the areas of greatest need.

The **size of the organisation** and the **complexity of its operations and controls** will be key determinants of the scale of monitoring required to obtain satisfaction as to the effectiveness of the risk management and internal control systems.

6.8.4 Review of internal control

In order to carry out an effective review of internal control, the board (or the audit committee) should regularly receive and review reports and information on internal control, concentrating on:

(a) What the **risks** are, and strategies for **identifying**, **evaluating** and **managing** them

(b) The **effectiveness** of the management and internal control systems in the management of risk; in particular, how risks are **monitored** and **how** any **weaknesses** have been dealt with

(c) Whether **actions** are being taken to **reduce** the risks found

(d) Whether the results indicate that **internal control** should be **monitored more extensively**

Annual reports should contain an **assessment** of the **effectiveness** of the **internal control over financial reporting**, and a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting. External auditors should report on this assessment, having carried out independent testing of the control system.

Interactive question 3: Internal control review

3.1 What sort of information would help the board carry out an effective review of internal control?

3.2 What sort of employee attitudes would help or hinder an effective review of internal control?

See **Answer** at the end of this chapter.

See **Answer** at the end of this chapter.

The2014 FRC *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* provides more detailed suggestions about what should be assessed as part of the regular review of internal controls:

Risk appetite and culture	• How has the board agreed the company's risk appetite? With whom has it conferred?

	• How has the board assessed the company's culture? In what way does the board satisfy itself that the company has a 'speak-up' culture and that it systematically learns from past mistakes? • How do the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and internal control systems? • How has the board considered whether senior management promotes and communicates the desired culture and demonstrates the necessary commitment to risk management and internal control? • How is inappropriate behaviour dealt with? Does this present consequential risks? • How does the board ensure that it has sufficient time to consider risk, and how is that integrated with discussion on other matters for which the board is responsible?
Risk management and internal control systems	To what extent do the risk management and internal control systems underpin and relate to the company's business model? • How are authority, responsibility and accountability for risk management and internal control defined, coordinated and documented throughout the organisation? How does the board determine whether this is clear, appropriate and effective? • How effectively is the company able to withstand risks, and risk combinations, which do materialise? How effective is the board's approach to risks with 'low probability' but a very severe impact if they materialise? • How has the board assessed whether employees have the knowledge, skills and tools to manage risks effectively? • What are the channels of communication that enable individuals, including third parties, to report concerns, suspected breaches of law or regulations, other improprieties or challenging perspectives? • How does the board satisfy itself that the information it receives is timely, of good quality, reflects numerous information sources and is fit for purpose? • What are the responsibilities of the board and senior management for crisis management? How effectively have the company's crisis management planning and systems been tested? • To what extent has the company identified risks from joint ventures, third parties and from the way the company's business is organised? How are these managed? • How effectively does the company capture new and emerging risks and opportunities?
	• How and when does the board consider risk when discussing changes in strategy or approving new transactions, projects, products or other significant commitments? • To what extent has the board considered the cost-benefit aspects of different control options? • How does the board ensure it understands the company's exposure to each principal risk before and after the application of mitigations and controls, what those mitigations and controls are and whether they are operating as expected?
Monitoring and review	• What are the processes by which senior management monitor the effective application of the systems of risk management and internal control? • In what way do the monitoring and review processes take into account the company's ability to re-evaluate the risks and adjust controls effectively in response to changes in its objectives, its business, and its external

	environment? • How are processes or controls adjusted to reflect new or changing risks, or operational deficiencies? To what extent does the board engage in horizon scanning for emerging risks?

6.8.5 Role of assurance procedures

Companies are increasingly asking accountants to provide assurance reports on specific operations or functions, in order to enable them to provide comfort to interested stakeholders. In the context of risk management, the subject matter for an assurance engagement may take various forms. The International Framework for Assurance Engagements gives the following examples:

- Systems and processes (such as the internal control system or IT system) which require assurance as to their effectiveness
- Behaviour (such as corporate governance, compliance with laws or regulation, human resource practices) which requires assurance as to compliance or effectiveness

To carry out any reviews effectively, the board is likely to have to rely on work by the **internal audit** function on the risk management and control systems. In the absence of an internal audit function, sufficient assurance should be obtained from other sources, such as assignments by an external accountancy firm.

Internal auditors will again be concerned to see that managers have made **adequate responses to risks**, have **designed robust risk management processes and internal control systems**, and that these risk management processes and controls **operate to mitigate the risks**.

Context example: Context example: Political risk

There are areas of political risk where internal audit may provide assurance about the adequacy of a company's control systems:

- For a company's new or existing investments or operations, and for sales or supply chains in international markets, monitoring rapid economic growth, instability or deterioration, increasing levels of foreign investment and significant changes in political leadership
- Reviewing potential changes in regulations or trade agreements; also any indications of social unrest or other looming security issues

Having taken an overall view earlier in the audit, internal auditors will concentrate on the **adequacy of risk management processes** and **controls** for each area to be covered, determine whether these processes are operating as intended, and seek to promote improvements where processes are inadequate or not operating as required.

Internal auditors will assess the **operation and effectiveness** of the **risk management processes** and the **internal controls** in operation to **limit risks**. A comprehensive risk audit will extend to the risk management and control **culture**.

Internal auditors' work on controls would include:

- reviewing the processes for identifying risks
- identifying the procedures for identifying and assessing risks, and controls at a corporate and operational level
- reviewing the completeness of documentation of risks and risk management measures
- testing controls
- advising on the contents of the board's statement to shareholders on the internal control system and the disclosure of material weaknesses

6.9 Performance monitoring and the board

Boards should monitor the performance of the company and its management. (One of the board's key responsibilities is to measure a company's performance against its objectives.) Performance monitoring is carried out mainly by means of regular reporting to the board by executive management. Typically the CEO, supported by the finance director, will submit performance reports to the board for scrutiny.

Actual performance should be compared with a benchmark, which may be a budget or a longer-term business plan or investment plan. Actual and plan are compared initially by means of key performance indicators or performance metrics.

6.9.1 Choice of metrics

We shall discuss data analysis and choice of metrics in Chapter 8 but, as a general principle, directors need to ensure that metrics link to the key **value drivers** of the business that relate to its strategy. For example, sales growth should be linked to new product sales or repeat business; and profit margin to prices, costs and sales volumes.

Identification of **leading indicators** that can predict future difficulties is particularly important. For example, falling customer satisfaction can result in future falls in revenue and a decline of the company's brand; however, in order to monitor this threat to future performance the board would need performance reports on customer satisfaction. Much of the financial information the board receives will be historical, and so will often be a **lagging indicator –** a measure of problems that have already occurred.

Some **non-financial matters**, for example customer and staff satisfaction, will be as important as financial matters. Many boards adopt a balanced scorecard approach, grouping key performance indicators into a number of different performance areas and setting targets for each performance indicator.

6.9.2 Setting performance targets

Having identified the metrics, the board must then decide the **targets** for those metrics. There needs to be a **mix of short- and long-term targets** and the targets may need to change if there are significant changes in external circumstances. Boards also need to be aware of investors' and analysts' views on what targets they expect companies to meet. A consistent failure to meet targets should trigger board action before investors exert pressure.

The board may consider the following issues when deciding whether to investigate further or take action:

(a) **Materiality – Small variations in a single period** are bound to occur and **are unlikely to be significant**.

(b) **Controllability –** Controllability must also influence the decision of whether to investigate further.

(c) **Variance trend –**If the same variance is £1,000 adverse every month, the **trend** indicates that the process is **in control** and the standard has been wrongly set.

6.9.3 Analysing information about metrics: revising forecasts

Directors need to obtain assurance from management that the metrics that are being reported are based on reliable data. Internal audit work may also provide assurance. Even if this assurance is obtained, directors should analyse the information critically, comparing it with their own knowledge of the company and external sources of information.

Another approach to obtaining assurance about performance is to obtain revised forecasts of expected future results.

A significant difference between a revised forecast and the original plan is likely to be much more significant than a comparison of performance to date with the plan.

Forecasts are a source of assurance to shareholders and lenders, as well as to the board itself. Listed companies often make announcements to the stock market about their expected results for the financial year, and update this information whenever the forecast changes.

7 Organisational structures and strategies

Section overview

The effectiveness of governance arrangements may significantly depend on how well organisational structure matches strategic and governance aims. We discussed business structure in depth in Chapter 3, and the issues discussed there are relevant, particularly the section on choosing a structure. In this section, we are interested in the suitability of corporate governance and organisational structures for implementing strategy.

8.1 Organisational structure

For governance purposes, an appropriate organisation structure depends on several factors.

(a) **The size of the organisation**. Size may be measured by number of employees, total assets and resources, and scale of activities.

(b) **Risks** to which the organisation is exposed and the risk management systems that will be required.

(c) **Centralisation/decentralisation**. Governance systems depend on where decisions are taken, by the board or by management, and at what level of management. As a general guide, decentralisation is likely to be more necessary in large and complex businesses. The extent of decentralisation of decision-making should also affect the design of performance reporting systems.

8.1.1 Strategic perspective of corporate governance

Boards often struggle to accommodate their strategic objectives within effective models of corporate governance, facing as they do the challenge of meeting both regulatory demands and changes in their business environments. Drew, Kelley and Kendrick (2005) suggest that a company's ability to engage in effective corporate governance is underpinned by five elements – culture, leadership, alignment, systems and structure. Importantly, however, these elements don't operate in isolation – each element is linked to, and supports, the others. (For example, when setting remuneration, it is important to ensure that incentives and rewards are aligned with an organisation's culture.)

8.1.2 Corporate governance and culture

Good corporate governance will be hindered by cultures where there is unethical behaviour, internal rivalry, excessive risk taking and intolerance of failure. Culture cannot be separated from leadership, and so leadership should be able to make sure that it encourages a positive culture. This may involve employee education and communication programmes. Key features of a positive culture include:

- beliefs and values being set out in the mission statement
- drive for success, but tolerance of occasional failures
- employees feeling free to air problems without fear of reprisals
- not an excessive focus on short-term numerical goals
- incentives and rewards not promoting unethical or illegal behaviour

8.1.3 Corporate governance and leadership

The experience of corporate failures and scandals has eroded faith in business leaders' integrity and truthfulness. Boards can improve organisational leadership by making sure that there is a balance of competences and experience in their senior teams, to ensure that they are directed towards:

- development of high corporate governance standards
- sensitivity to important stakeholders
- longer-term strategic and ethical considerations

8.1.4 Corporate governance and alignment

Alignment can be understood as the state in which organisational resources, processes and strategies are working together. The Sarbanes-Oxley Act has required firms to improve the alignment between governance, financial reporting and risk management functions. This has meant a higher profile for, and greater focus on the effectiveness of external and internal audit. When governance processes, financial rigour and risk management are found wanting, the results can be disastrous.

8.1.5 Corporate governance and systems

Lack of strong financial control systems can lead to disaster, as recent corporate failures have demonstrated. When Parmalat collapsed in 2003, the company was £15 billion more in debt than had been reported, and there had been numerous failings in basic financial controls and systems.

In the US, Sarbanes-Oxley requires companies to report on the effectiveness of internal controls over financial reporting. As well as financial control and reporting systems, IT systems play an important role in establishing a strong internal control environment.

Again, auditors have an important role to play in reporting on the effectiveness of such controls.

8.1.6 Corporate governance and structure

Boards need to consider how to structure themselves to support good governance and risk management.

Implementing a suitable structure involves establishing systems that will promote communication across the organisation. When that structure is combined with culture, leadership and systems features as described above, a company's risk management ability is improved.

8.2 Governance and strategy implementation

8.2.1 Strategic planning decisions

The key decisions about corporate strategy, including risk appetite, should be taken at board level, with the board fully accountable to shareholders for the success or failure of their chosen strategy.

(a) Within the framework of the overall corporate strategy, decisions must be taken about supporting functional strategies. Such strategies should consider the business environment, the stage of growth and the firm's position in the industry life cycle.

(b) Functional strategies may be decided at board level, or planned by management and subject to board approval.

(c) Functional strategies should be consistent with the overall corporate strategy. For example, the board may decide on a strategy for sales growth and decide on a target for 5% sales growth over each of the next five financial years. Management may then develop a sales strategy for achieving the board's strategic targets, and submit this to the board for approval.

(d) In very large organisations, the board may set an overall corporate strategy for the group, and divisional boards may then decide on strategy for their business unit. Within each business unit, functional strategy planning may then be delegated to management.

8.2.2 Strategic planning and unexpected change

The process of strategic planning described above is a process for preparing and approving a formal business plan. The plan may cover a period of several years, during which changes will occur that were not envisaged when the plan was originally formulated.

Companies need to respond to unforeseen changes – threats or opportunities – and develop new strategies to meet the change in circumstances.

Strategic decisions for responding to change may have to be taken quickly, especially if there is a short-lived opportunity or if a major new risk has emerged that creates an immediate threat to the business. Quick decisions are often needed in particular in businesses that operate in a volatile and continually changing environment.

8.2.3 Implementing strategy

Strategies are implemented by management. The level in the management hierarchy at which responsibility for strategy implementation rests will depend on the extent of centralisation or decentralisation of decision-making.

Managers who are responsible for strategy implementation should be accountable to their senior and ultimately to the CEO. The CEO is then accountable to the board. Accountability for strategy implementation should be a key feature of a risk management system and performance reporting system.

8.2.4 Monitoring strategy implementation

Within a system of responsibility management, managers should monitor the implementation of strategy by their subordinates, and the board should monitor the implementation of strategy by the executive management.

The quality of corporate governance within a company depends to a considerable extent on the quality of monitoring by the board.

9 Legal framework of governance

Section overview

Boards must have regard to the wide variety of laws and regulations that affect the organisation.

10.1 Legal requirements relating to the company

Companies are increasingly subject to laws and regulations with which they must comply. The most significant laws and regulations for companies differ according to the industry in which the company operates and the geographical reach of its operations. Some examples are given in Figure 6.1.

Figure 1.1: Figure 6.1: Laws and regulations affecting organisations

For the purpose of your examination, you should be aware of the nature of the legal framework within which a company operates, and the implications for corporate governance. You will not be required to know the law in detail. Much of the discussion in this section relates to UK law, but UK law is used here as a convenient example. It provides just one example of a governance regime and legal aspects of governance will vary according to country and jurisdiction.

10.1.1 Company law

Company law is the source of much regulation about the way that companies are formed and governed, including rules relating to the annual report and accounts, the requirement for external audits, annual general meetings, and so on.

The UK Companies Act also sets out seven statutory duties of directors which have relevance to corporate governance and so are listed below. These duties apply to NEDs as well as executive directors.

Legal duty	
Duty to act within powers	The directors owe a duty to act in accordance with the company's constitution, and only to exercise powers for the purposes for which they were given. They have a fiduciary duty to the company to exercise their powers *bona fide* in what they honestly consider to be the interests of the company. They also should act in accordance with decisions reached at board and company meetings and in compliance with the law.
Duty to promote success of company	Directors have a duty to promote the success of the company. However, UK law does not define what should be regarded as the success of a company. This is down to a director's judgement in good faith. This is important, as it ensures that business decisions are for the directors rather than the courts. No guidance is given for what the correct course of action would be where the various duties are in conflict.

Legal duty	
	The UK Companies Act 2006 provides directors with a list of issues to keep in mind. When exercising this duty, directors should consider: • the consequences of decisions in the long term • the interests of their employees • the need to develop good relationships with customers and suppliers • the impact of the company on the local community and the environment • the desirability of maintaining high standards of business conduct and a good reputation • the need to act fairly as between all members of the company
Duty to exercise independent judgement	Directors should be independent-minded, and should not be improperly influenced by the opinions of others. Being independent-minded is not the same as being an independent NED: as explained previously, there are different interpretations of 'independence'.
Duty to exercise reasonable skill, care and diligence	A director owes a duty to their company to exercise reasonable care, skill and diligence. There are two aspects to this duty of care. (a) A director should act in a manner that would reasonably be expected of a person performing the same role as director. (b) A director should also act in accordance with the particular skills, knowledge and experience that they actually have.
Duty to avoid conflict of interest and duty to disclose interests in transactions with the company	Directors should avoid a conflict of interests with their company. A conflict of interest in the context of directors' duties most often means a situation where directors face influences that tempt them to act in a self-interested way rather than in the best interests of the company. Conflicts of interest may arise when a director is involved in a business transaction with their company. The company's constitution may not allow directors to have any contracts with the company. If it allows contracts, then directors are likely to have to disclose their interest to the rest of the board. Legal provisions may reinforce or be stricter than the constitution, prohibiting certain transactions (for example, loans to directors) and only allowing some transactions if they are ratified by a shareholder vote (transactions above a certain size). Directors of listed companies may face stricter legal requirements. Directors are required to disclose to the other directors the nature and extent of any interest, direct or indirect, that they have in relation to a proposed transaction or arrangement with the company. When a conflict of interests arises, the director should take measures to end the conflict, or should resign from the board.
Duty not to accept benefits from third parties	Directors should not accept benefits from third parties conferred by reason of them being a director, or doing (or omitting to do) something as a director. (Taking bribes in the UK would be a criminal offence as well as a breach of company law.)

From a corporate governance perspective, it is also useful to recognise the legal provisions for the departure of directors from the board and the appointment of new directors. A director may leave office in the following ways:

(a) Resignation (written notice may be required): When directors resign, either voluntarily or under pressure from colleagues, they may negotiate compensation for loss of office.

(b) Not offering themselves for re-election when their term of office ends: Company law should include a requirement for directors to submit themselves for re-election every so often. (In the UK, directors should submit themselves for re-election every three years, although for companies with a premium listing, the UK Corporate Governance Code requires annual re-election of all directors.)

(c) Failing to be re-elected: When shareholders are dissatisfied with decisions or actions by the board, one way in which they can express their dissatisfaction is to vote against the re-election of particular individuals.

Resignations and not standing for re-election are the most common methods of making changes to the board.

10.1.2 Criminal law: fraud

Several aspects of criminal law have relevance to corporate governance. These include the laws against fraud and theft, bribery, insider dealing and money laundering.

Definition

Fraud: An intentional act by one or more individuals among management, those charged with governance (management fraud), employees (employee fraud) or third parties involving the use of deception to obtain an unjust or illegal advantage. Fraud may be perpetrated by an individual, or colluded in with people internal or external to the business.

In the UK, the Fraud Act defines three classes of fraud:

- Fraud by false representation
- Fraud by failing to disclose information
- Fraud by abuse of position

An offence has occurred in any of these classes if a person has acted dishonestly and with the intent of making a gain for themselves or for someone else, or of inflicting a loss on someone else.

Definition

Theft: According to the UK Theft Act 1968, a person is guilty of theft if they dishonestly appropriate property belonging to another with the intention of permanently depriving the other of it.

Internal control systems should be designed so as to include checks and procedures for the prevention or detection of fraud and theft. However, they are both a form of deceit that can make prevention and detection difficult.

Internal controls to prevent or detect human errors may also help to prevent or detect fraud and theft.

10.1.3 Bribery

Some countries, including the UK, have a criminal law against giving or receiving bribes by a company and its officials or representatives. The key points of the UK Bribery Act2010are as follows:

- Bribery is an intention to encourage or induce improper performance by any person, in breach of any duty or expectation of trust or impartiality.
- Bribery may amount to an offence for the giver ('active bribery') and the receiver ('passive bribery').
- Improper performance will be judged in accordance with what a reasonable person in the UK would expect. This applies, even if no part of the activity took place in the UK and where local custom is very different.
- Reasonable and proportionate hospitality is not prohibited.
- Facilitation payments (payments to induce officials to perform routine functions they are otherwise obligated to perform) are bribes.
- Bribing a foreign public official is an offence.

- If companies (or partnerships) fail to prevent bribes being paid on their behalf, they have committed an offence punishable by an unlimited fine. A defence for a company against accusations of bribery is to have' adequate procedures' in place for the prevention of bribery.
- If a bribery offence is committed by a company (or partnership), any director, manager or similar officer will also be guilty of the offence if they consented or were involved with the activity which took place.

Guidance published in 2011 by the UK Ministry of Justice highlighted five areas where the risk of bribery and corruption may be high:

- **Country**. Countries with high levels of corruption, lacking anti-bribery legislation and which fail to promote transparent procurement and investment policies.
- **Sectoral**. Higher risk sectors include the extractive and large-scale infrastructure sectors.
- **Transaction**. Risky transactions include charitable and political contributions, licences and permits, and transactions relating to public procurement.
- **Business opportunity**. Potentially risky projects include high-value projects, projects involving many contractors or intermediaries, and projects not apparently undertaken at market price or which lack a clear business objective.
- **Business partnership risk**. Risky situations could include the use of intermediaries in transactions with foreign public officials, involvement with consortia or joint venture partners and relationships with politically exposed persons.

10.1.4 Insider dealing

Insider dealing is a criminal offence. Essentially, insider dealing involves using confidential (undisclosed) information about a company to deal in a company's shares (or to encourage someone else to deal in a company's shares) for financial benefit.

For directors, an obvious example of insider dealing would be using the advance knowledge they have of the company's results to make gains before the information is released to the market. Rules in many countries therefore include prohibition of directors dealing in shares during a **close period**, defined as a specific period (60 days, for example) before the publication of annual or period results.

10.1.5 Money laundering

Money laundering is a form of fraud. It is essentially a process where the perpetrator attempts to legitimise the proceeds of any crime (dirty money made good). Proceeds of crime can include activities such as drug trafficking, terrorism, shoplifting, theft, tax evasion and other financial criminal activity. As a form of fraud, the emphasis is on concealing the illegal source of the money, which makes it difficult to detect, especially given that the transactions are rarely linked to one country.

Relevant legislation in the UK includes:

- **The Terrorism Act 2000**.It is a criminal offence in the UK to finance or facilitate the financing of terrorism.
- **The Proceeds of Crime Act 2002**.Three money laundering offences under this Act are:

  Section 327– An offence is committed if a person conceals, disguises, converts, transfers or removes from the jurisdiction property which is, or represents, the proceeds of crime which the person knows or suspects represents the proceeds of crime.

  Section 328– An offence is committed when a person enters into or becomes concerned in an arrangement which he knows or suspects will facilitate another person to acquire, retain, use or control criminal property and the person knows or suspects that the property is criminal property.

  Section 329– An offence is committed when a person acquires, uses or has possession of property which he knows or suspects represents the proceeds of crime.
- **Money Laundering Regulations** –these were updated in 2017 to provide that relevant persons should adopt a more risk-based approach towards anti-money laundering, in particular in how they conduct due diligence.

The Economic Crime Plan 2019 to 2022 sets out 7 priority areas that were agreed in January 2019 by the Economic Crime Strategic Board, the ministerial level public-private board charged with setting the UK's strategic priorities for combatting economic crime:

(a) develop a better understanding of the threat posed by economic crime and our performance in combatting economic crime

(b) pursue better sharing and usage of information to combat economic crime within and between the public and private sectors across all participants

(c) ensure the powers, procedures and tools of law enforcement, the justice system and the private sector are as effective as possible

(d) strengthen the capabilities of law enforcement, the justice system and private sector to detect, deter and disrupt economic crime

(e) build greater resilience to economic crime by enhancing the management of economic crime risk in the private sector and the risk-based approach to supervision

(f) improve our systems for transparency of ownership of legal entities and legal arrangements

(g) deliver an ambitious international strategy to enhance security, prosperity and the UK's global influence

The plan demonstrates the UK's commitment to making the fight against economic crime as effective as possible by means of greater scope, transparency and action.

Some companies are at greater risk than others of breaching the laws against money laundering, such as banks. Affected companies must assess the risk of money laundering in their business and take necessary action by identifying the risks and taking measures, for example by refusing to enter into business transactions with customers who are suspected of money laundering.

These risks are exacerbated by the fact that one of the central money laundering techniques is transferring funds from a jurisdiction with high transparency (such as the UK, or the US which has appointed the Office of Terrorism and Financial Intelligence to counter these threats) to a location where financial scrutiny is more opaque. Although examples of countries that participate in money laundering (usually by a passive omission of regulatory action rather than any form of active encouragement) are gradually disappearing, there is still a need for international efforts to counter this global problem. The G-7 set up the Financial Action Task Force (FATF) in 1989 which continues to set the tone for anti-money laundering policy worldwide .

10.1.6 Civil law

Areas of commercial law which may impact on businesses include:

- carriage by land and sea
- marine, fire, life and accident assurance
- bills of exchange
- manufacture and sale of consumer goods

Businesses may also be affected by various aspects of property law, including:

- possession and rights over land
- transfer of property
- landlord and tenant law
- manufacture and sale of consumer goods

10.1.7 Contract law

Contract law will have a significant impact on a business. Contracts may be made with suppliers, landlords, customers and so on.

Context example: Context example: Consumer Rights Act 2015

The UK Consumer Rights Act 2015consolidates existing consumer protection legislation. The Act requires goods to be of satisfactory quality, fit for a particular purpose and as described. These same provisions now also apply to digital content. Any statement that a company makes when a consumer is deciding to enter into a contract, or even after entering into the contract, is now a binding contractual term. If the statements are misleading, a claim may now be brought for breach of contract rather than just misrepresentation.

The following diagram is a summary of the key points:

It is almost invariably the case that the two parties to a contract bring with them differing levels of bargaining power. A contract may be made between a large retail company and an individual, for example. In such cases, the agreement is likely to be in the form of a standard form contract, prepared by the dominant party and which the other party has no choice but to take or leave. Alternatively, the parties to the contract will negotiate the terms between them.

Having entered into a contract a business faces the following risks:

(a) The contract is unenforceable.

A contract will be unenforceable where it is not in the correct **form**. Note that, increasingly, contracts are made electronically and an electronic signature can be used as evidence of the validity of a contract in the same way as a written signature (s8 Electronic Communications Act 2000).

(b) The contract is void or voidable.

A contract may be void or voidable in the following situations:

- Lack of capacity
- Absence of free will
- Illegality
- Mistake
- Misrepresentation

The consequences of a contract being rendered void or voidable are as follows:

Void	A **void contract** is not a contract at all. The parties are not bound by it and if they transfer property under it they can generally recover their goods even from a third party.
Voidable	A **voidable contract** is a contract which one party may set aside. Property transferred before avoidance is usually irrecoverable from a third party.

(c) The contract is not discharged.

A contract is normally discharged by performance. Where a party does not perform its contractual obligation sufficiently, it is said to be in **breach of contract**, unless the contract has been discharged by frustration or it has some other **lawful excuse**. A lawful excuse may apply in the following circumstances:

- Where they have tendered performance but this has been **rejected**
- Where the **other party** has made it **impossible** for them to perform
- Where the parties have by **agreement** permitted **non-performance**

The majority of contractual disputes will not reach the courts and may be resolved by negotiation, arbitration or some other means, such as mediation, adjudication and expert determination. However, where this is not possible the court may award one of the following remedies:

- Damages (designed to compensate the claimant by putting him in the position he would have been in, if the contract had been performed)
- Specific performance (where damages are not an adequate remedy)
- Injunction (ie, the defendant is directed to take positive steps to undo something he has already done in breach of contract)

Damages are the most common form of remedy to be awarded by the courts. A company in breach of contract may need to recognise a provision for damages or disclose a contingent liability depending on the specific nature of the situation and the assessment of the likely outcome of the court proceedings.

10.1.8 Agency

Agency is a very important feature of modern commercial life and describes the relationship that exists where one party, the agent, acts on behalf of another, the principal. In practice, there are many examples of agency relationships to which you are probably accustomed, such as estate agents and travel agents. However, you should appreciate, in particular, how a director may be held to be an agent of the company and bind the company by his acts and also how a partner is an agent of the partnership and may bind the firm by his acts.

Agency by consent

An agency can be expressly created either orally or in writing. There is only one exception to this, which is that if the agent is to execute a deed on the principal's behalf (for example a conveyance of land or a lease exceeding three years) then the agency must be created by deed. Essentially this means that the agent is given a power of attorney.

Agency by estoppel

Agency by estoppel arises by operation of law and is no less effective than an agency expressly created. It arises in the following situation:

- when the words or **conduct of the principal** give to a **third party** the **impression** that the person who purports to contract with the third party **is the agent** of the principal; and
- the **third party**, as a result, **acts upon this**.

The principal is 'estopped', or prevented, from denying the existence of the agency. For example, where a business presents an employee to customers and other entities it is in business with as a director they will be treated in law as such (shadow director) even if they are not officially registered at Companies House as a director of the company.

The law implies the following duties into any contract of agency:

Duties	Explanation
Accountability	An agent must provide full information to their principal of their agency transactions and account to them for all monies arising from them. If they accept from the other party any commission or reward as an inducement to make the contract with them, it is considered to be a bribe and the contract is fraudulent. The principal who discovers that their agent has accepted a bribe may dismiss the agent and recover the amount of the bribe from them.
No conflict of interest	The agent owes to their principal a duty not to put themselves in a situation where their own interests conflict with those of the principal.
Performance	The agent who agrees to act as agent for reward has a contractual obligation to perform their agreed task. (An unpaid agent is not bound to carry out their agreed duties unless there is other consideration.) Any agent may refuse to perform an illegal act.
Obedience	The agent must act strictly in accordance with their principal's instructions insofar as these are lawful and reasonable. Even if they believe disobedience to be in their principal's best interests, they may not disobey instructions (unless they are asked to commit an illegal or unreasonable act).
Skill	An agent undertakes to maintain the standard of skill and care to be expected of a person in their profession.
Personal performance	The agent is usually selected because of their personal qualities and owes a duty to perform their task themselves and not to delegate it to another. (However, they may delegate in certain circumstances, for example a solicitor acting for a client would be obliged to instruct a stockbroker to buy or sell listed securities on the stock exchange.)
Confidence	The agent must keep in confidence what they know of their principal's affairs even after the agency relationship has ceased.

Conversely, an agent has the following **rights** (or duties owed by the principal):

Rights of the agent	Explanation
Indemnity	The agent is entitled to be repaid their expenses and to be indemnified by their principal against losses and liabilities, provided their acts are done properly within the limits of their authority. They may recover expenses properly paid even if they were not legally bound to pay; for example, a solicitor who pays counsel's fees (which the counsel cannot recover at law) may reclaim this expense from their client.
Remuneration	The agent is also entitled to be paid any agreed remuneration for their services by their principal. The entitlement to remuneration may have been expressly agreed or may be inferred from the circumstances, for example by reference to trade or professional practice. If it is agreed that the agent is to be remunerated but the amount has not been fixed, the agent is entitled to a reasonable amount.
Lien	The agent has the right to exercise a lien over property owned by the principal, ie, a right to retain and hold goods pending payment of sums owed to them.

10.1.9 Negligence

Negligence is the most important modern tort. To succeed in an action for negligence, the burden of proof is on the claimant to prove, on **a balance of probabilities**, that:

- the defendant owed **a duty of care** to the claimant to avoid causing injury, damage or loss
- there was **a breach of that duty** by the defendant
- **in consequence** the claimant suffered **injury, damage or loss**

Duty of care

It is not possible to give a clear statement of the law as to when a duty of care exists for the purposes of negligence, since the law has evolved over many years as it has had to be applied to extremely varied situations and many factors have influenced the courts' decisions. Whether or not a duty of care exists will be assessed on the basis of some or all of the following four tests. These were formulated by the House of Lords in *The Nicholas H* (*Marc Rich & Co v Bishops Rock Marine*) *1995* case.

Test	Meaning
(a) Reasonably foreseeable	Was the damage reasonably foreseeable by the defendant as damage to the claimant at the time of the negligent act or omission?
(a) Proximity	Is there sufficient proximity, or neighbourhood, between the parties?
(a) Fair, just and reasonable	Is it fair, just and reasonable that the law should impose a duty on the defendant on the facts of the case?
(a) Public policy	Is there a matter of public policy that requires that no duty of care should exist?

Breach of duty

Whether or not there has been a breach of duty is a question of fact. In certain circumstances where the reason for the damage is not known, but it can fairly be said that it would not have occurred without the defendant's lack of care, the claimant can argue **res ipsa loquitur** ('the facts speak for themselves') and the court will infer that the defendant was in breach of the duty of care.

The standard of care needed to satisfy the duty of care is a question of law. Broadly speaking, it is the standard of 'a reasonable man, guided upon those considerations which ordinarily regulate the conduct of human affairs' (*Blyth v Birmingham Waterworks Co 1856*).

The following principles have been established by case law:

Principle	Explanation
Particular skill	If the defendant professes a **particular skill**, the standard is that of a reasonable person with that skill, ie, a reasonable accountant or reasonable electrician.
Lack of skill	**Peculiarities or disabilities** of the defendant are not relevant, so the standard for a learner driver is that of a reasonable driver and for a trainee accountant, that of a reasonable accountant.
No hindsight	The test is one of **knowledge and general practice existing at the time**, not hindsight or subsequent change of practice.
Body of opinion	In broad terms, a claim against a professional person will fail if they can point to a **body of professional opinion that supports the approach** taken and which the court considers to be reasonable.
Advantage and risk	In deciding what is reasonable care, the balance must be struck between **advantage and risk**. (For example, a driver of a fire engine may exceed the normal speed on their way to the fire but not on the way back.)
Emergency	If a defendant acts negligently in an **emergency situation**, this will be taken into account – the test is that of a reasonable man in the defendant's situation.
Vulnerability	If A owes a duty of care to B and A knows that B is unusually vulnerable, a higher standard of care is expected.

Loss caused by breach

A person will only be compensated if he has suffered actual loss, injury, damage or harm **as a consequence** of another's actions. As a general rule, loss is represented by personal injury or damage to property, or financial loss directly connected to such injury (for example, loss of earnings) or property damage. Such **consequential** economic loss that is related in this way is more readily recoverable than **pure** economic loss.

10.1.10 Employment and social security law, and health and safety regulations

An entity which employs individuals has a number of responsibilities under the terms of the employment contract in common law and in statute. One of the key distinctions which a business needs to be able to make therefore is between an employee and a contractor. An employee is someone who is employed under a **'contract of service'**, ie, a contract of employment. An independent contractor is someone who works under a **contract for services** and is also described as 'self-employed'.

There are three essential elements, or conditions, that **must** be present in order for the contract of service (and thus the employer/employee relationship) to exist, namely:

Condition	Explanation
Personal service	The employee must have agreed to provide their own work and skill in the performance of a service for their employer. However, the fact that an employee is able to delegate that performance in limited circumstances (for example when they are sick or only with permission) will not mean that this condition is not met.
Control	There must be some element of control exercisable by the employer over the employee.
Mutuality of obligations	There must be an obligation on the employer to provide work and an obligation on the employee to do that work. Thus a 'casual worker' who works as and when required, even if in preference to others, cannot be an employee because there is no 'mutuality of obligations'.

If these factors are not present there can be no contract of service. The fact that they are present, however, does not mean that there **will** be a contract of service. The level of service and degree of control will be taken into account along with a number of other factors.

There are several other **practical reasons** why the distinction between a contract of service (employed) and a contract for services (self-employed) is important.

Significance of the distinction		
	Employee	**Self-employed**
Wrongful dismissal	Can claim wrongful dismissal.	Cannot claim wrongful dismissal.
Employment protection	There is legislation that confers protection and benefits upon employees under a contract of service, including: • Minimum periods of notice • Entitlement to statutory redundancy payment • Remedies for unfair dismissal • Health and safety protection (Sometimes the protection is subject to the employee having completed a certain amount of continuous service.)	Note that increasingly, employment protection is given to 'workers' rather than 'employees'. 'Workers' is more widely defined and will often include those normally regarded as independent contractors as well as employees. It is important to note which term the legislation applies to; for example, statutory protection against unfair dismissal applies to 'employees', but working time protection applies to 'workers'. Note too that statutory health and safety obligations on employers often relate to both employees and independent contractors.
Insolvency	In liquidation, an employee has preferential rights as a creditor for payment of outstanding salary and redundancy payments, up to certain limits.	Self-employed contractors only have the normal, non-preferential rights of any creditor, in the event of insolvency.
Implied terms	There are rights and duties implied in an employment contract by common law and statute, for example a mutual duty of trust and confidence.	These implied rights and duties do not generally apply to a contract for services.
Tortious acts	Employer is generally vicariously liable for tortious acts of employees, committed in the course of employment.	Liability of person hiring an independent contractor for contractor's acts is severely limited unless there is strict liability.
Taxation	Deductions for income tax must be made by an employer under PAYE (Schedule E) from salary paid to employee.	The self-employed are taxed under Schedule D and are directly responsible to HMRC for tax due.
VAT		An independent contractor may have to register for, and charge, VAT.
Social security	Employers must pay secondary Class 1 contributions on behalf of employees. Employees make primary Class 1 contributions. There are also differences in statutory sick pay and levies for industrial training purposes.	Independent contractors pay Class 2 and 4 contributions.

With the current trend in increasingly flexible working practices in some cases this distinction is becoming more difficult to make. There is an increased risk that an entity has responsibilities for individuals under employment law which it is not aware of. This could increase the risk of penalties.

Employer's implied duties

The employer owes the following duties at common law:

To pay reasonable remuneration	This duty is subject to any express provision, for example to pay a rate fixed by the parties, or to pay nothing during a lay-off.
To indemnify employees	To **indemnify the employee** against expenses and losses incurred in the course of employment.
Health and safety	This is normally expressed as a duty to protect the employee against reasonably foreseeable risks to their **health, safety** and welfare at work. Health and safety obligations are also imposed by statute. This common law duty is threefold and incorporates the obligations to provide: • safe plant and appliances • a safe system of work • reasonably competent fellow-employees
To provide work	Generally speaking, an employer will not be liable for failing to provide work as long as they continue to pay wages (so liability is more likely to arise where someone is paid on a commission basis).
To provide accurate reference (where one is provided)	An employer does not have a duty to provide a reference (but if they do provide one, they must exercise reasonable care and skill to ensure that the information contained in it is accurate and gives a fair impression of the employee). In particular, an employer cannot divulge information that is not known to the employee (for example customers' complaints against the employee).
Not to disclose confidential information	The employer must not divulge confidential information about the employee to a third party without the employee's consent.
To maintain mutual trust and confidence	The employer must treat the employee with due respect and consideration. They must not, for example, conduct their business in a disreputable fashion, thereby damaging the employee's reputation and future employment prospects.

Legislation also imposes a number of implied duties on employers, often implementing European Directives on employment law issues. Many of these duties are concerned with 'family-friendly' employment and the 'work-life balance', for example provisions regarding maternity and paternity rights, flexible working arrangements and time off work. The principal duties implied by statute are as follows:

Subject	Duty
Pay	Under legislation protecting equal pay, contractual employment terms such as sick pay, holiday pay and working hours should be as favourable as those given to an employee of the opposite sex who is performing equal work or work of equal value, unless a 'genuine material factor' exists that justifies the discrepancy (for example, employees in London receiving a higher hourly rate than employees in regional locations where living costs are lower).
Health and safety	The Health and Safety at Work Act 1974 imposes general duties on employers, including a duty to ensure the continuing good health, safety and welfare of his employees, as far as is practicable. This general duty includes the following obligations: • Provide and maintain plant and systems of work that are safe and without risk •

Subject	Duty
	• Make arrangements to ensure safe use, handling, storage and transport of articles/substances • Provide adequate information, instruction, training and supervision • Maintain safe places of work and ensure that there is adequate access in and out • Provide a safe and healthy working environment
	Certain additional duties are imposed on employers in particular categories, for example designers and manufacturers who must ensure that the articles designed or manufactured are safe and that there is adequate testing and examination. There are also extensive health and safety regulations which may be generally applicable or specifically applicable to particular hazards or risks. Contravention of the Act is an offence punishable by an unlimited fine and/or up to two years' imprisonment. If an offence is committed by a company, any director or other officer who consented to or was responsible for commission of the offence will also be guilty and liable to the penalties mentioned.
Discrimination	Not to discriminate on grounds of race, sex, disability, religion or belief, sexual orientation or age.

Employee's implied duties

Common law implies a number of duties on the part of the employee into any contract of employment:

Duty of faithful service (fidelity)	The employee has a **fundamental duty of faithful service** or fidelity to their employer. Thus an employee who works for an employer's competitor in their spare time, or who frustrates the commercial objectives of their employer, is in breach of this duty.
To obey lawful and reasonable orders	The employee must show **obedience** to the employer's instructions unless they require them to: • do an unlawful act; • expose themselves to personal danger (not inherent in their work); or • do something outside their contract.
Not to misuse confidential information	This duty will not necessarily cease when the employment ceases. (Note that when someone invents or writes something as part of their employment, the right to the patent or copyright will normally belong to their employer.)
To exercise reasonable care and skill	The employee must demonstrate reasonable **competence, care and skill** in the performance of their work, bearing in mind the degree of skill and experience that the employee professes to have.
Personal service	The contract of employment is a personal one and so the employee may not delegate their duties without the employer's express or implied consent.
Trust and confidence	This is a mutual obligation imposed on both parties and is based on respect and consideration for each other. An employee should not, for example, make unjustifiable complaints or false accusations about their employer.

Further details on employment law are covered in your Law Study Manual.

10.1.11 Environmental law and regulation

Environmental law and regulation covers a number of different areas, including:

- air
- chemicals
- conservation
- energy
- noise and nuisance
- pesticides and biocides
- radioactive substances
- waste
- water

Within each category, there is a range of legislation. For example, legislation on air quality includes regulations regarding aerosol dispensers, clean air acts, climate change acts and crop residues (burning) legislation. For any business, it is therefore critical that it identifies which regulations are relevant to its business and ensures that it complies with the provisions of these. The company may employ the services of a consultant in order to help it understand and apply the legislation with a view to avoiding any breaches and the potential penalties that may arise as a consequence.

Breaches of environmental regulations can have significant consequences, both directly (as a result of the fines) and indirectly (as a result of the bad publicity).

10.1.12 Data protection

As we mentioned in Chapter 2 – in the context of 'big data' – companies are collecting and storing increasingly large amounts of data. However, while this data can help improve the quality of their decision-making, it is also important that organisations remember their legal responsibilities in relation to personal data (for example, about customers, account holders and staff).

The EU General Data Protection Regulations (GDPR) – or the Data Protection Act (2018) in the UK – controls how personal data is used by organisations, and requires them to ensure that data is kept secure, accurate and up to date. (Personal data is any data or information that can be used to identify a person, including their name, address, date of birth, or email address.)

The Act notes that everyone responsible for using personal data has to follow strict data protection principles, and must ensure the information is:

- used fairly, lawfully and transparently
- used for specified, explicit purposes
- used in a way that is adequate, relevant and limited to only what is necessary
- accurate and, where necessary, kept up to date
- kept for no longer than is necessary
- handled in a way that ensures appropriate security, including protection against unlawful or unauthorised processing, access, loss, destruction or damage

The last point, about security, could be particularly significant in the context of cyber security, which we will consider in more detail in Chapter 9.

10.1.13 Legal vs ethical obligations

Law and ethics are not the same thing – a business practice such as tax avoidance might be regarded as unethical, but is not necessarily illegal. Integrity, honesty and openness in business dealings are not specifically demanded by legal regulation, and explicit reference to ethical principles are not generally included in corporate governance codes.

Questions of ethics are however inherent in all aspects of corporate governance, and most companies do recognise that for their businesses to be successful, they need to conduct their activities in an ethical (as well as a legal) manner. Ethics is considered in more detail in Chapter 19.

10.2 Compliance with laws and regulations

Directors and management should ensure that their company complies with relevant laws and regulations.

Context example: Context example: Tax avoidance

It was reported in December 2017 that European Commission investigators were looking at royalties paid by Ikea's Dutch entity, Inter Ikea, to its subsidiary in low-tax Luxembourg between 2006 and 2010. In April 2017, the Commission ordered Amazon to pay €250 million (£221 million) in back taxes to the Luxembourg government after ruling that a 2003 tax deal amounted to illegal state aid.

The EU's competition chief also asked Apple to provide details of its latest tax structure as regulators tried to recover €13 billion (£11.5 billion) in back taxes to Ireland. This came after a ruling that Ireland had granted Apple illegal state aid in the form of generous tax benefits, which allowed the company to pay almost no tax on a significant proportion of its global sales.

Leaked documents showed that Apple had moved a subsidiary to Jersey in order to continue avoiding billions in taxes, after an EU crackdown in 2013.

Both Apple and Amazon denied any wrongdoing, and a spokesperson for Inter Ikea Systems said the company was committed to paying taxes in accordance with laws and regulations wherever it operates.

Source: https://www.independent.co.uk/news/business/news/ikea-tax-investigation-eu-commission-inter-margrethe-vestager-big-small-a8116321.html [Accessed 7 August 2018]

The consequences of failing to comply with laws and regulations will depend on the nature of the offence, and the jurisdiction in which the offence occurs. Fines for breaching the law or contractual arrangements could be very high, and there may also be a risk that offences could lead to a significant loss of business.

Large companies may establish a compliance department whose responsibility is to monitor compliance with relevant laws and regulations. The name given to a compliance department may vary. For example, compliance with health and safety regulations may be assigned to a health and safety department. When a company finds it necessary to establish one or more compliance departments, the costs of compliance can be high.

Compliance can be particularly complex for international companies that operate in different countries with differing jurisdictions.

Context example: Context example: Compliance framework

The South African King Report sets out the principles underlying a company's governance framework that should ensure compliance with relevant laws and regulation.

(a) **The board should ensure that the company complies with applicable laws and considers adherence to non-binding rules, codes and standards**

Compliance is an ethical imperative, which should be understood not only in terms of the obligations that laws create, but the rights and protection that they afford. The board should consider adherence to non-binding rules, codes and standards if it would constitute good governance practice. Compliance should be systematically managed and should be a regular item on a board's agenda.

(b) **The board and each individual director should have a working understanding of the effect of the applicable laws, rules, codes and standards**

Directors have a duty to familiarise themselves with the general content of laws and regulations, to be able to adequately discharge their fiduciary duties in the best interests of the company and their duty of care, skill and diligence. The business should have processes to ensure that the board is continually informed of relevant laws, rules, codes and standards.

(c) **Compliance risk should form an integral part of the company's risk management process**

Risks of non-compliance should be managed through the risk management processes. However, this does not imply that compliance is optional, depending on whether the risk assessment warrants it. A compliance function can form part of a broader risk management function.

(d) **The board should delegate to management the implementation of an effective compliance framework and processes**

Management should develop and implement the compliance policy, and the board should approve it and monitor compliance. The compliance policy should be aligned with other business efforts and objectives. Compliance should be part of the code of conduct to entrench a culture of compliance. A compliance culture should also be encouraged through leadership, establishing appropriate structures, education and training, communication and measurement of key performance indicators relevant to compliance.

The following aspects of control systems are particularly important.

10.2.1 Establishing a culture of compliance

Board commitment to compliance with the law is an important overall control. Directors may seek to establish a commitment against breaches of specific laws by a formal statement, setting out a zero tolerance policy and spelling out the consequences for employees or managers who transgress.

As with other areas, **communication** of the organisation's procedures and policies, and **training** in their application, will be very important in helping to establish the culture. Training should include general training on the threat of bribery on induction, and also specific training for those involved in higher risk activities such as purchasing and contracting.

However, while establishing the right culture is an important part of taking effective action to combat corruption, a culture that is ambiguous or not enforced may adversely affect the success of other measures. This may occur if managers and staff feel that they are getting mixed messages. They may believe that they are expected to do what it takes to earn sufficient returns in environments where ethical temptations exist, or that ethically dubious conduct will be ignored or implicitly accepted.

10.2.2 Code of conduct

As well as being central to communication with employees, a publicly communicated code reassures those doing business with the organisation and can act as a deterrent to misconduct. For example, a code may include provisions about dealing truthfully with suppliers and refraining from seeking or participating in questionable behaviour to secure competitive advantage. However, there may be the problem that staff do not feel the code is relevant to them.

10.2.3 Risk assessment

Identification of circumstances where non-compliance with laws may be a problem must be built into business risk assessments. Sensitive areas could include hazardous activities for health and safety laws, disputes with staff for employment law, or the activities of intermediaries or agents, or staff within the organisation responsible for hospitality or promotional expenditure for anti-bribery legislation. Risks may change over time (for example, as the business enters new markets) and so may need to be reassessed. A poor internal control environment may also be a factor that contributes significantly to increased risk.

10.2.4 Operational compliance

A strong tone at the top and the ethical code may be undermined by a lack of detailed guidance on the implementation of procedures to ensure compliance with laws.

However detailed the procedures, they will not be able to give absolute assurance that corrupt activities will not take place. Staff may not understand why operational controls are required, how they should operate and who should be operating them. They may misinterpret the requirements, or may encounter dubious situations not covered by guidance. They may assume that conduct not forbidden by the guidance is legitimate.

There is also the issue that detailed guidance is meant to ensure compliance with the law. However, the law may not be entirely clear.

10.2.5 Whistleblowing

A business's guidance should make it clear that managers and staff should seek guidance about, and disclose, any activities that are questionable. Staff should also have the opportunity to make suggestions for improvement in prevention and compliance procedures.

10.2.6 Monitoring

As part of their regular monitoring of risk management, the board should receive reports on compliance with significant legislation. The board must also consider whether systems need to be improved as the risk environment changes. Events that may result in changes to systems include changes of government, changes in legislation or changes in the activities of the business.

The board's monitoring of compliance may be assisted by compliance audits. These may be carried out by internal auditors, or external specialists for areas in which there is a lack of in-house expertise, or external assurance is required or felt to be desirable.

Summary

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, complete the following knowledge diagnostic and check you are able to confirm you possess the following essential learning from this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	
1.	What are the OECD principles of corporate governance? (Topic 1)
2.	How do different stakeholders contribute to corporate governance? (Topic 2)
3.	What can limit the effectiveness of a board's decision making? (Topic 3)
4.	What is the role of non-executive directors? (Topic 3)
5.	For effective governance what factors should be considered in relation to organisational structure? (Topic 4)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
2 GFE	This question looks at corporate governance in the not-for-profit sector rather than for a listed, profit seeking entity. SBM exam questions could be based on profit seeking or not-for-profit organisations so ensure you are aware of similarities and differences in corporate governance requirements for different entity types.
3 HEC	In self-test question 3 you are asked to consider internal controls and the role and responsibilities of internal audit. This topic is covered in Section 3 of the chapter and tested via IQ3 so ensure you review these areas before looking at the question. The question requires some basic technical knowledge but most of your answer will come from using the scenario to generate ideas. Many SBM questions rely less on technical knowledge and more on scenario application.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Safetex plc (task 2)	This short question examines the corporate governance implications arising from an acquisition. You need to consider the impact on the majority shareholder, in terms of the proportion of the company he will own. In SBM you can develop your discussion as much as you deem necessary within the time constraints of the requirement. You could include calculations (see the

Question	Learning benefit from attempting this question
	solution) if you feel that they enhance your point and if you have time to do so. When discussing other corporate governance issues there are many points you could make. Ensure your answer is as broad as possible.
Looster Lagoona plc (Exhibit 5 task 3)	The third task looks at the impact on corporate governance arising from the following; the removal of an employee representative from the board committees, the appointment of two additional independent non-executive directors, and the separation of the chairman and chief executive roles. This question requires you to apply your knowledge of basic corporate governance to the scenario. In addition, you are asked to consider the impact of two refinancing packages on corporate governance. Methods of financing and refinancing were covered in your Financial Management studies and will be recapped in later SBM chapters. Use your existing knowledge and common sense to attempt this part of the question at this point. Your knowledge will naturally improve as you progress through your studies.
Quinter plc (Exhibit 6 task 4)	In task 4 of this question you are asked to identify and explain improvements in corporate governance that would assist Quinter's management control and performance management. Consider the features of good corporate governance that you have studied in Chapter 6 and identify any gaps or weaknesses that can be improved upon in Quinter.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

1 UK Corporate Governance Code

- Identifies the Principles, and supporting Provisions, that a company should apply to help ensure the governance of the company contributes to its long term sustainable success and helps it achieve its wider objectives. The Code addresses five main areas:
  - Board Leadership and Company Purpose
  - Division of Responsibilities
  - Composition, Succession and Evaluation of the Board
  - Audit, Risk and Internal Control
  - Remuneration

Self-test questions

Answer the following questions.

- Discuss the extent to which non-executive directors can contribute to the effectiveness of corporate governance for an unlisted company that may seek a listing in the future.

- GFE is a registered charity with 150 employees and 350 volunteers, providing in-home care for elderly persons who are unable to fully take care of themselves. The company structure has no shareholders in a practical sense although a small number of issued shares are held by the sponsors who established the charity many years previously. GFE is governed by a seven-member board of directors. The chief executive officer (CEO) chairs the board, which comprises the chief financial officer (CFO) and five independent, unpaid non-executive directors who were appointed by the CEO, based on past business relationships. You are one of the independent members of GFE's board.

  The CEO/Chair sets the board agendas, distributes board papers in advance of meetings and briefs board members in relation to each agenda item. At each of its quarterly meetings, the board reviews the financial reports of the charity in some detail and the CFO answers questions. Other issues that regularly appear as agenda items include new government funding initiatives for the client group, and the results of proposals that have been submitted to funding agencies, of which about 35% are successful. There is rarely any discussion of operational matters relating to the charity, as the CEO believes these are outside the directors' experience and the executive management team is more than capable of managing the delivery of the in-home care services.

  The board has no separate audit committee but relies on the annual management letter from the external auditors to provide assurance that financial controls are operating effectively. The external auditors were appointed by the CEO many years previously.

  GFE's board believes that the company's corporate governance could be improved by following the principles applicable to listed companies.

  Requirement

  Recommend how GFE's board should be restructured to comply with the principles of good corporate governance.

- Owned and operated by Highland Energy Company (HEC), the 1,000 km Highland oil pipeline has become a vital source of economic growth in its home country of Zedland. The oil carried by the pipeline is loaded onto ships at Zedtown port and exported to the neighbouring country of Exland.

  Zedland is a developing country with few labour regulations and very little legislation on employee pay and conditions. This has enabled HEC to use a large proportion of poorly-paid immigrant labour to build and maintain the pipeline as it crosses over rough terrain. Because of the multinational workforce, there are often language barriers and difficulties in communicating work practices and because of the remoteness of much of the work on the pipeline, conditions are harsh. Motivation and morale are often low and industrial relations are poor. The company has found it difficult to recruit the skilled technical people it needs.

  During a recent winter storm, a connection in the pipeline was fractured, resulting in an oil leak. Seeking to protect both the pipeline and the environment, the Zedland government's industry minister wrote to the recently appointed CEO, asking him to respond to rumours about poor internal controls in HEC and to introduce measures to reduce the chances of a repetition.

  In response to the industry minister's letter, the HEC board reviewed internal controls and two resolutions were agreed. The first was that the company should establish a formal internal audit function and second, that a full review of any barriers to sound internal controls in the company should be carried out. It was decided that in responding to the minister, the CEO should convey both the board's resolve on internal audit and also an honest review of HEC's problems in achieving sound internal controls.

  Requirements

  1.1 The reasons why the implementation of sound internal controls has been difficult at HEC.

1.2 The ways in which an internal audit function might provide assurance in order to make an effective contribution to HEC.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Adrian

Arguments for appointment

Knowledge of QP

Adrian has **exceptionally good long-term knowledge** of QP through his involvement with the investment over 15 years. Adrian's knowledge should mean that he can provide expert scrutiny of the performance of executive management.

Knowledge of industry

As a result of Adrian's long experience as investment analyst, he should have **wide knowledge of the industry and economy** as well as of QP, although he has not worked in the manufacturing sector. This should mean that he is able to make an informed contribution to board discussions about strategy, and have the weight of knowledge to be able to challenge effectively the plans of executive directors from the perspective of an institutional investor.

Arguments against appointment

Independence

As the representative of a significant institutional investor in QP, Adrian cannot be regarded as an independent non-executive director under governance best practice such as the UK Corporate Governance Code. Adrian has perhaps been suggested because current board members believe, based on their previous dealings with him, that he will be reluctant to challenge their strategies. Also Adrian does not appear to be stepping down from the City Pensions' board. If he does not do so, his duties to **promote the best interests of City Pensions and QP may conflict**. Other significant investors may consider that Adrian's appointment would give City Pensions a privileged position and demand board representation themselves.

Lack of fresh perspective

Adrian may **not be able to bring a fresh perspective** to the affairs of QP. As City Pensions' representative, Adrian has already had chances to raise concerns about QP's strategies or how QP is being governed. Possibly, Adrian is unlikely to raise new issues if appointed as a director.

Recommendation

Adrian's connections mean that he cannot be regarded as an **independent non-executive director**. This would limit his contribution to the board, as he could not serve on **audit or remuneration committees** under governance best practice. The board would be some way short of fulfilling the requirement of governance best practice that at least half the board should be independent non-executive directors. For this reason, Adrian should not be appointed.

Nicole

Arguments for appointment

ICAEW membership

Nicole's membership of ICAEW means that she is subject to **ICAEW's ethical code**. This should guarantee that she brings to the board essential qualities such as **integrity and objectivity**. Adherence to ICAEW's **continuing professional education requirements** will obligate Nicole to make sure that she has the relevant, up to date, knowledge needed to contribute effectively as a director.

Wide experience

Nicole can bring a **fresh perspective** to the board, based on experience of a number of different sectors. Her experience as finance director on the bank's board, together with ICAEW membership, means that Nicole has the **recent financial knowledge**, highlighted by governance reports as a requirement for the audit committee. Nicole will also bring contacts in the banking sector, which may be useful when QP is dealing with major lenders.

Arguments against appointment

Independence

Nicole is about to retire. We are **not given details of any other sources of income** that Nicole has, although Nicole probably has a pension from the bank.

Nicole's fees as non-executive director may be a **significant proportion of her income** going forward. There is the risk that Nicole may be less willing to challenge and upset other directors and jeopardise this source of income.

Lack of previous involvement in sector

Nicole does not appear to have had **previous involvement** in this specific sector. Nicole will need to have a **more extensive induction programme** than Adrian would.

Recommendation

Nicole should qualify as an independent non-executive director. The benefits that Nicole's ICAEW membership and wider experience will bring should mean that Nicole is offered a directorship. Her role should include chairing the audit committee.

Helen

Arguments for appointment

Political knowledge

Helen should be able to bring expert knowledge of the **political and legal environment** to the board, helping the board assess risks in this area. QP may be able to use the political contacts that Helen has, and use her expertise to lobby against damaging changes to legislation.

Other directorships

Helen is currently on **two other boards**. The perspective she gains from serving on these boards may inform her contribution to QP's board. Helen may be able to **benchmark** what QP is doing against practice elsewhere. She should also have gone through an **induction process** at these companies and be aware of responsibilities in law and under governance best practice.

Arguments against appointment

Time

Helen is already a director of two other companies and this may limit the time that can be spent as a director of QP to an **unacceptably low level**.

Lack of previous involvement in sector

Helen does not appear to have had any previous experience in the chemical sector, unlike Adrian. Helen also appears to lack Nicole's financial knowledge.

Recommendation

Helen should be considered for one of the vacant directorships. However, before Helen is appointed, the board should obtain **guarantees that she will spend sufficient time** on QP's affairs.

Answer to Interactive question 2

2.1 The effectiveness of non-executive directors may be limited by the following factors.

Having the same perspective as executive directors

2.1 The corporate governance reports stress the importance of non-executive directors possessing independent judgement and being appointed by a nomination committee. However, the nomination committee may restrict its search to **directors** who will '**fit in**' with the rest of the board, and may be **unwilling to recruit** from a **diversity of backgrounds**, for example stakeholders such as employees. In addition, many non-executive directors will only agree to serve on the boards of companies if they admire the company's chairman or its way of operating.

Lack of independence

2.1 In many companies, non-executive directors have been appointed through business or social contacts with directors. It may be difficult to find **non-executive directors** who **fulfil the independence requirements** of the corporate governance reports or freedom from any relationship that compromises independence.

Lack of business knowledge

2.1 This can be the other side of the coin to the problem of lack of independence. Potential non-executive directors who have good knowledge of the business and industry may have gained that knowledge through links with the company in the past.

Lack of human resource management

2.1 Limited time may mean that non-executive directors do not have proper **induction** into the company, nor **proper updating and refreshment** of their skills and knowledge of the company. Their **performance may not be appraised** regularly; it should form part of an **annual appraisal** of the **board's activities**.

Limited time

2.1 The most knowledgeable and effective non-executive directors are likely to have other significant demands on their time. As directors, they have to fulfil **certain legal requirements**. Apart from their contributions to the main board, they will also probably spend time at **meetings of board committees** such as the audit and remuneration committees. The limited involvement resulting from the lack of time may limit their ability to contribute to board meetings, since they are **unable to obtain** a **broad enough picture** of what is happening throughout the organisation.

Information available

2.1 Non-executive directors' contribution will also depend on the information that is readily available to them as directors. This will be influenced by the quality of the **organisation's information systems**, and also the **willingness** of **executive directors** to supply information about their activities.

Role of board

2.1 Corporate governance reports (such as the UK Corporate Governance Code) stress the importance of non-executive directors being involved in **strategic decisions**. If non-executive directors are involved in formulating strategy, they can fulfil their key role, that of **warning of potential problems** and hence **preventing trouble**. However, board meetings may focus almost entirely on **current operational matters** and **short-term operational results**. In addition, a focus at board meetings on short-term results may mean that non-executive directors **assess** the **performance** of the organisation using short-term indicators and its management, and do not focus on **longer-term issues**, such as changes in product mix or re-engineering of the organisation's processes.

Inability to resist pressures

2.1 Non-executive directors have limited options when faced with a **united group** of **executive directors** who are determined to push through a policy with which the non-executive directors disagree. Their ultimate weapon is **resignation** but, if all or a number of non-executive directors resign, they may precipitate a crisis of confidence in the company. Alternatively, they can remain in office , but then if serious problems arise, the executive directors may have to depart from the board, leaving the non-executive directors with the responsibility for 'picking up the pieces'.

2.2 The effectiveness of audit committees could be improved in the following ways.

Appointment requirements

2.2 **Appointments** could be **recommended** by a vote at the **annual general meeting**. Alternatively, certain stakeholders, for example employees, could have the right to appoint a member. These measures might improve the independence of committee members.

The **term of office** of committee members could be **limited** to ensure the committee retained a fresh perspective.

When nominating potential members, the selection process could be biased towards **recruiting members** with **financial accounting experience**, or **experience of large control systems**. Members who have accountancy experience will be able to question the judgements that management make when preparing accountancy information.

Expansion of responsibilities

2.2 There are various ways in which the committee's remit might be expanded. They could have responsibility for **reviewing compliance** with **laws and regulations** such as environmental legislation or ethical codes. Certain **transactions** could also be **referred automatically** to them for review.

Internal audit

2.2 As a major function of many audit committees is to oversee the role of internal audit, it follows that a **more effective internal audit function** will lead to more effective operation of the audit committee, by improving the quality of information that the audit committee review.

Statutory backing

2.2 Audit committees may become more effective if their establishment by certain organisations is made **compulsory**. The recommendations of internal audit will also be **reinforced by stricter accounting and auditing standards**.

Improvement in operations

2.2 Changes that might improve the way audit committees operate include the following.

(1) Having **clear terms of reference**, agreed by the board

(2) Establishment of an **annual plan**, giving details of the areas on which the committee will focus

(3) Establishment of **standards** for the **frequency** of, and **form of reporting** to, the main board

(4) Regular **review** of the **effectiveness** of the audit committee, including whether its recent work has been correctly focused

Answer to Interactive question 3

3.1 The UK's Institute of Internal Auditors suggests that the board needs to consider the following information in order to carry out an effective review.

(1) The organisation's **code of business conduct**

(2) Confirmation that line managers are **clear as to their objectives**

(3) The overall results of a **control self-assessment** process by line management or staff

(4) **Letters of representation** ('comfort letters') on internal control from line management (confirmations about the operation of systems or specific transactions)

(5) A **report** from the audit committee on the **key procedures** that are designed to provide effective internal control

(6) **Reports from internal audit** on audits performed

(7) The audit committee's **assessment** of the **effectiveness of internal audit**

(8) Reports on **special reviews** commissioned by the audit committee from internal audit or others

(9) Internal audit's **overall summary opinion on internal control**

(10) The **external auditors' report on weaknesses** in the accounting and internal control systems and other matters, including errors, identified during the audit

(11) **Intelligence** gathered by board members during the year

(12) A **report on avoidable losses** by the finance director

(13) A **report on any material developments** since the reporting date and up to the present

(14) The board's proposed wording of **the internal control report** for publication

3.2 The following employee attitudes will be relevant.

Response to management behaviour

3.2 Employees may not take controls with the **same degree of seriousness** that management does. They will take into account how strictly controls are applied by senior managers, whether senior managers override controls, and whether follow-up action is taken by management if control weaknesses are identified.

Realism of controls

3.2 If employees see **controls as unrealistic** because, for example, there is insufficient time to operate them, they may not take management review of controls seriously.

Employee collusion

3.2 If employees do collude, the evidence available to management may be **undermined**. Collusion may not necessarily be hiding fraud. It could be a shared intention to thwart what is seen as unnecessary bureaucracy. The fact, for example, that there are two signatures on a document does not necessarily mean that it has been checked properly.

Focus on certain controls

3.2 If a **lot of emphasis is placed on certain controls**, reports on which the annual review is based will stress the operation of those controls and provide less detail of other controls that are also significant.

Prioritisation

3.2 Many employees may feel that controls are bureaucracy and, as such, interfere with more important day to day work. This may mean, for example, that controls are **not operated when they should be**, but some time later, and so the evidence the annual review is relying on may not be as strong as it appears.

Reliance on memory

3.2 Some controls may be dependent on **knowledge held in the mind of employees**. The employees concerned may be happy about this because it reinforces their position, but it can lead to a lack of clarity about whether controls have operated and also inconsistency and misunderstanding, when controls depend on the attitudes of the person operating them.

Answers to Self-test questions

1 **Business expertise**

2 Non-executive directors can broaden the level of expertise on the board, which may be fairly limited.

Strategy

3 A non-executive director should be able to bring an independent viewpoint on strategy. A non-executive director may be more inclined to of the board.

Performance scrutiny

4 A non-executive director can **scrutinise the work done by executive management** and monitor how performance is reported to the board. This will include whether the company is **developing reporting systems** that will be sufficient to provide the reliable information that will be required if it seeks and obtains a listing.

Risk

5 A non-executive director can also **review the reports on risks and risk management** that derive from the system established by the risk management function. The director will assess whether risks appear to be **adequately managed**, and also that the systems **fulfil the requirements** of **governance best practice** with which the company will have to comply if it obtains a listing.

Directors and management

6 The non-executive director can assess the performance of directors and managers, and can be responsible for advising on a remuneration structure that **fairly rewards the performance of directors**. They can also advise on what the **concerns of external shareholders** will be if the company seeks a listing and how management will best **demonstrate its accountability** to a new shareholder base.

7 **Split of role of chairman and CEO**

8 Governance reports recommend that the roles of CEO and chairman should be split between different individuals, to avoid there being an excessive concentration of power in the hands of one individual. At present, the CEO is able to **manipulate the information** the board receives, to protect his position. It seems best for one of the existing NEDs to be appointed as chairman. Splitting the roles emphasises that the two jobs are distinct, with the **CEO running the charity** and the **chairman running the board**. The chairman can ensure the CEO is **accountable** for his actions by, for example, ensuring the board **has enough information** to exercise oversight of the CEO.

Appointment of secretary

9 The board's functioning would be better if someone acted as company secretary. The secretary could undertake a number of tasks currently undertaken by the CEO, including **distributing board minutes** in advance of meetings and **briefing board members in relation to each agenda item**. This would free up the time of the CEO or chairman. The secretary should be accountable to the board collectively, and should, if necessary, have the **independence** to come into conflict with the CEO if the secretary believes it is in the interest of GFE.

More executive directors

10 Governance reports typically suggest that at least half the board should be independent, non-executive directors – to ensure an appropriate balance between executive and non-executive directors. At GFE five out of seven directors are non-executives, which does not appear to be an appropriate balance. The UK Higgs report commented that there is a greater risk of distortion or withholding of information, or lack of balance in the management contribution, when there is only one, or a very small number, of executives on the board. GFE should consider appointing one or two more executive directors; for example, an operations director. This would also help with **succession planning**, and lead to a greater emphasis on **risk management** and **operational control** at board level.

Audit committee

11 Appointing a **separate audit committee** will enable the main board to concentrate more on strategic and operational matters, leaving the audit committee to undertake the **detailed financial review** that is a major part of current board meetings. The audit committee should also be **responsible for the appointment of auditors** and for **liaison with them about further work, including a review of controls**. At present, the auditors' ability to exercise independent scrutiny could be questioned, since they have been appointed by the CEO. Governance reports recommend that all members of the committee should have sufficient financial expertise to contribute effectively, and that one member should have **relevant and recent financial experience**. New directors may therefore need to be recruited to fulfil this requirement or existing members **receive training**.

Nomination committee

12 A nomination committee of NEDs would **oversee the appointment of the new directors** that GFE's board appears to need. The committee would also review other important issues of board functioning that have not been considered recently, such as:

- the **balance between executives and NEDs**
- whether there are **gaps between the skills, knowledge and experience** possessed by the current board and what the board ideally should have
- the need to **attract board members from a variety of backgrounds**
- whether GFE will need to pay **some NEDs** to attract the right candidates

Independent NEDs

13 Governance reports recommend that at least half the board are **independent NEDs**, without business or financial connections, who face re-election regularly. Independent NEDs will be particularly important for GFE as it is a charity, and stakeholders will rely on NEDs to provide unbiased scrutiny of how the executive directors are conducting its affairs. It is possible that none of the current NEDs can be classed as independent, since they have all been appointed on the basis of previous business connections.

Expert NEDs

14 NEDs with **experience of the charity sector** need to be appointed. The reason given for not discussing operational matters, that these are outside the directors' experience, indicates that as a body, the NEDs have **insufficient expertise** at present. The CEO's belief that the executive management team is more than capable of managing the delivery of the in-home care services misses the point. NEDs should **scrutinise**, and if necessary **challenge**, the way the CEO is running operations, drawing on their own experience.

Stakeholder representation

15 There appears to be a **lack of stakeholder representation** on the board, with fund providers, volunteer helpers and users of GFE's services not being represented. Having a user representative on the board would mean that the board received **direct feedback on the effectiveness of the charity's activities**. Stakeholder representatives could also **provide feedback** to the stakeholders they represent on the reasoning behind board decisions and GFE's current strategy.

Changes in board membership

16 It seems that new NEDs need to be appointed to provide the **expertise and independence** the board is currently lacking. Corporate governance reports recommend that the board should not be so large as to be unwieldy; therefore, some of the new board members may have to replace existing board members.

2 Difficulties in internal control

Nature of terrain

3 The pipeline is 1,000 km in length and thus is a very substantial project to oversee and maintain. Much of the pipeline runs over rough terrain, that is often afflicted by poor weather. It can therefore be difficult to monitor the condition of the whole pipeline and assess the magnitude of likely threats to it.

Failure to recruit quality staff

4 Staff have had to endure poor working conditions and have not been paid particularly well. These factors have meant that it has been difficult to recruit staff with the technical expertise required to operate certain controls effectively.

Poor morale

5 The morale of HEC's workforce has been low for some time. This has resulted in poor industrial relations, a lack of awareness of the importance of control mechanisms, a lack of risk awareness and a lack of trust between staff and management. All of this will mean that staff have not been motivated to operate controls to the high standards required.

Reliance on foreign labour

6 HEC has had to recruit foreign labour in order to maintain the levels of staffing required for operations. There have, however, been problems with workers from overseas. Language difficulties appear to have meant that some staff have not been able to understand any complex technical instructions they have been given and have failed to do as they were told and operate internal controls properly.

6.1 The establishment of an internal audit function, reporting to the board of directors, is a first step in improving the situation at HEC. This function will have a number of roles, and can bring several benefits by providing assurance in the following areas.

Effectiveness of internal controls

6.2 An internal audit will carry out a monitoring role, assessing the adequacy of HEC's internal control systems and testing the effectiveness of their operations. The nature of HEC's operations means that control systems will necessarily be complex, and it is important that evidence is obtained through the work of internal audit that the control systems are functioning effectively.

Risk management systems

6.3 Similarly, internal audit's review of risk management provides evidence that systems are operating effectively in the challenging environment in which HEC operates. Internal audit will test whether HEC has systematic processes in place for identification of strategic risks, and effective and thorough strategies for dealing with the significant risks that have been identified.

Compliance with laws and regulations

6.4 HEC is likely to be operating in a highly-regulated environment. The legal penalties imposed upon the company for breaches could be extremely severe. Internal audit work will review whether the systems HEC has in place are sufficient to ensure compliance with laws and regulations, and that staff are fulfilling the requirements imposed upon them. Internal audit will also review compliance with the contractual terms of the supply agreement with customers in Exland.

Appendix

Tax Tables FA2020

Syllabus area: Administration

SUBMISSION DATES

Submission dates for 2020/21 personal self-assessment tax returns

Return filed online	Later of: 31 January 2022 3 months from the date of issue of return
Paper returns	Later of: 31 October 2021 3 months from the date of issue of return

Submission dates for corporation tax returns

Must be filed by 12 months from the end of the period of account.

Submission dates for PAYE information: Real Time Information

Information	**Filing date**
Full Payment Submission (FPS)	On or before the day the employee is paid
P60 (to employees)	31 May following the tax year end
P11D	6 July following the tax year end

PAYMENT DATES

Payment dates for income tax

Payment	**Filing date**
First interim payment (1)	31 January in the tax year
Second interim payment (1)	31 July following the tax year end
Balancing payment	31 January following the tax year end

(1) Interim payments are not required if the tax paid by assessment for the previous year was less than:

£1,000; or

20% of the total tax liability (income tax and Class 4)

Payment dates for capital gains tax

Capital gains tax is payable by 31 January following the tax year end.

Payment dates for corporation tax	
Corporation tax	Nine months and one day after the end of an accounting period
Corporation tax by instalments – large companies	The 14th day of months 7, 10, 13 and 16 counted from the start of a 12-month accounting period
Corporation tax by instalments – very large companies	The 14th day of months 3, 6, 9 and 12 counted from the start of a 12-month accounting period

Payment dates for VAT

	Due date
Electronic payment	7 calendar days after the last day of the month following the end of the return period
Direct debit payment	Collected automatically 3 working days after electronic payment due date

MAIN PENALTY PROVISIONS

PENALTIES FOR INCORRECT RETURNS

The penalties are a percentage of the potential lost revenue

Reason for penalty	Maximum penalty	Minimum penalty with unprompted disclosure	Minimum penalty with prompted disclosure
Careless action	30%	Nil	15%
Deliberate but not concealed action	70%	20%	35%
Deliberate and concealed action	100%	30%	50%

PENALTIES FOR FAILURE TO NOTIFY

Failures to notify chargeability to tax, or liability to register for tax that leads to a loss of tax will result in a penalty. The penalties are a percentage of the potential lost revenue.

Reason for penalty	Maximum penalty	Minimum penalty with unprompted disclosure		Minimum penalty with prompted disclosure	
Deliberate and concealed action	100%		30%		50%
Deliberate but not concealed action	70%		20%		35%
		>12m	<12m	>12m	<12m
Any other case	30%	10%	Nil	20%	10%

COMPANIES: PENALTIES

Offence	Maximum Penalty
Failure to notify chargeability within 12 months of end of accounting period	See above: penalties for failure to notify

Corporation tax: penalties for late filing of a corporation tax return

Offence	Penalty(1)
Late return, up to 3 months late	£100 fixed penalty, or £500 for persistent failure
Return more than 3 months late	£200 fixed penalty, or £1,000 for persistent failure
Return filed more than 18 months but less than 24 months after end of return period	Tax geared penalty of 10% of tax unpaid 18 months after end of return period
Return filed more than 24 months after end of return period	Tax geared penalty of 20% of tax unpaid 18 months after end of return period

(1) The tax geared penalty is charged in addition to the fixed penalty but only one of each type of penalty is charged.

INDIVIDUALS: PENALTIES

Offence	Maximum Penalty
Failure to notify chargeability by 5 October following tax year end	See above: penalties for failure to notify
Late payment of income tax or capital gains tax: (1)	
Unpaid 30 days after payment due date	5% of tax unpaid
Unpaid 6 months after payment due date	Further 5% of tax unpaid
Unpaid 12 months after payment due date	Further 5% of tax unpaid

(1) Late payment penalties do not apply to payments on account.

Income tax and CGT: penalties for late filing of a self-assessment return

Offence	Maximum Penalty
Late return	Immediate £100 fixed penalty
Return more than 3 months late	Daily fixed penalties of up to £10 per day for maximum 90 days
Return more than 6 months but less than 12 months late	Further tax geared penalty of 5% of tax due (minimum £300)
Return 12 months late	Further tax geared penalties apply (minimum £300): 100% if deliberate and concealed(1) 70% if deliberate but not concealed(1) 5% in all other cases

(1) These tax geared penalties are reduced for disclosure as per penalties for incorrect returns.

PAYE: penalties for late returns/ submissions

Number of employees	Monthly penalty
1 to 9	£100
10 to 49	£200
50 to 249	£300
250 or more	£400

If the form is more than three months late, an additional penalty is due of 5% of the tax and NIC that should have been reported.

Additionally, there is a £300 penalty per late P11D return, with an extra £60 per day charged if the delay continues.

PAYE: penalties for late payment

	No of late payments	% of tax unpaid(1)
	1st	nil
	2nd, 3rd & 4th	1%
	5th, 6th & 7th	2%
	8th, 9th & 10th	3%
Penalties for late payment of in-year PAYE depend on the number of defaults in the tax year	11th or more	4%
Where a penalty has been imposed and the tax remains unpaid at 6 months		5%(2)
Where a penalty has been imposed and the tax		5%(2)

remains unpaid at 12 months

(1) The percentage penalty is applied to the total amount that is late in the relevant tax month.

(2) The 6 month and the further 12 month penalties are in addition to the initial penalty for late payment.

VAT: penalties

Offence	Maximum Penalty
Failure to notify liability for registration or change in nature of supplies by person exempted from registration	See above: penalties for failure to notify

VAT: late payment or late filing – default surcharge

Default involving late payment of VAT in the surcharge period[(1)]	Surcharge as a percentage of the VAT outstanding at the due date
First	2%[(2)]
Second	5%[(2)]
Third	10%[(3)]
Fourth	15%[(3)]

(1) Default if late payment of VAT or filing of VAT return and surcharge liability notice issued, but default surcharge only applies on late payment.

(2) No surcharge if it would be less than £400.

(3) Minimum £30 payable.

VAT errors

An error made on a VAT return can be corrected on the next return provided it was not deliberate and does not exceed the greater of:

- £10,000 (net under-declaration minus over-declaration); or
- 1% x net VAT turnover for return period (maximum £50,000)

Alternatively, a 'small' error which is not deliberate may be corrected via the submission of form VAT652. Errors which are not 'small' or errors which are deliberate should be notified to HMRC on form VAT652.

RECORD KEEPING PENALTY

Offence	Maximum Penalty
Failure to keep and retain tax records	£3,000 per tax year / accounting period

INCOME TAX RATES: 2020/21

	Rate	Taxable income band
Main rates		
Basic rate	20%	£1 – £37,500
Higher rate	40%	£37,501 – £150,000
Additional rate	45%	Over £150,000
Savings rates		
Starting rate for savings	0%	£1 - £5,000
Savings income nil rate	0%	First £1,000 or £500
Savings basic rate	20%	Otherwise chargeable at basic rate

	Rate	Taxable income band
Savings higher rate	40%	Otherwise chargeable at higher rate
Savings additional rate	45%	Otherwise chargeable at additional rate
Dividends rates		
Dividend nil rate	0%	First £2,000
Dividend ordinary rate	7.5%	Otherwise chargeable at basic rate
Dividend upper rate	32.5%	Otherwise chargeable at higher rate
Dividend additional rate	38.1%	Otherwise chargeable at additional rate
Default rates		
Default basic rate	20%	
Default higher rate	40%	
Default additional rate	45%	
INCOME TAX RELIEFS		**2020/21**
Personal allowance		£12,500

CGT RATES

	2020/21
Gains falling within the remaining basic rate band	10%
Gains exceeding the basic rate band	20%

CORPORATION TAX RATES

	FY 2020
Tax rate	19%
Augmented profits limit for corporation tax payment dates – large companies	£1,500,000
Augmented profits limit for corporation tax payment dates – very large companies	£20,000,000

NATIONAL INSURANCE CONTRIBUTIONS

	2020/21		
NIC CLASS 1	**Annual**	**Monthly**	**Weekly**
Primary threshold (PT)	£9,500	£792	£183
Secondary threshold (ST)	£8,788	£732	£169
Upper earnings limit (UEL)	£50,000	£4,167	£962
Apprentice upper secondary threshold (AUST) for under 25s	£50,000	£4,167	£962
Upper secondary threshold (UST) for under 21s	£50,000	£4,167	£962

NIC CLASS 1	2020/21 Annual	Monthly	Weekly
Employment allowance (per year, per employer)	£4,000		
Class 1 Primary contributions on earnings between PT & UEL	12%		
Class 1 Primary contributions on earnings above UEL	2%		
Class 1 Secondary contributions on earnings above ST where employee aged 21 or over and not an apprentice under the age of 25	13.8%		
Class 1 Secondary contributions on earnings between ST & AUST for apprentices under the age of 25	0%		
Class 1 Secondary contributions on earnings above AUST for apprentices under the age of 25	13.8%		
Class 1 Secondary contributions on earnings between ST & UST for employees under the age of 21	0%		
Class 1 Secondary contributions on earnings above UST for employees under the age of 21	13.8%		
Class 1A contributions	13.8%		

	2020/21
NIC CLASS 2	
Normal rate	£3.05 pw
Small profits threshold	£6,475 pa
NIC CLASS 4	
Annual lower profits limit (LPL)	£9,500
Annual upper profits limit (UPL)	£50,000
Percentage rate between LPL & UPL	9%
Percentage rate above UPL	2%

VAT	
Standard rate of VAT	20%
Reduced rate of VAT	5%

Syllabus Area: Income Tax & NIC

INCOME TAX RATES: 2020/21	Rate	Taxable income band
Main rates		
Basic rate	20%	£1 – £37,500
Higher rate	40%	£37,501 – £150,000
Additional rate	45%	Over £150,000
Savings rates		

INCOME TAX RATES: 2020/21	Rate	Taxable income band
Starting rate for savings	0%	£1 - £5,000
Savings income nil rate	0%	First £1,000 or £500
Savings basic rate	20%	Otherwise chargeable at basic rate
Savings higher rate	40%	Otherwise chargeable at higher rate
Savings additional rate	45%	Otherwise chargeable at additional rate
Dividends rates		
Dividend nil rate	0%	First £2,000
Dividend ordinary rate	7.5%	Otherwise chargeable at basic rate
Dividend upper rate	32.5%	Otherwise chargeable at higher rate
Dividend additional rate	38.1%	Otherwise chargeable at additional rate
Default rates		
Default basic rate	20%	
Default higher rate	40%	
Default additional rate	45%	

INCOME TAX RELIEFS	2020/21
Personal allowance(1)	£12,500
Marriage allowance(2)	£1,250

(1) The personal allowance of any individual with adjusted net income above £100,000 is reduced by £1 for every £2 of adjusted net income above the £100,000 limit.

(2) A spouse or civil partner who is a basic rate taxpayer or who has income of less than the personal allowance is allowed to transfer £1,250 of their personal allowance (ie 10% rounded up to the next £10) to their spouse/civil partner provided the recipient spouse is a basic rate taxpayer.

CAPITAL ALLOWANCES

First year allowances available

100% on new and unused zero emissions goods vehicles

100% on new and unused low emission cars ie electrically propelled or with CO_2 emissions of not more than 50 g/km

100% on electric vehicle charging points

Annual investment allowance

£200,000 pa of expenditure incurred by any business on certain plant and machinery from 1 January 2021.

Writing down allowances

18% pa in the main pool

COMPANY VANS, CARS AND FUEL

Van scale charge

No charge applies if there is insignificant private use

£2,792 if van has zero CO_2 emissions and £3,490 if it has CO_2 emissions

Additional £666 if private fuel provided for the van

Company cars – cash equivalent	
Zero emissions cars	0% of list price

Company cars – cash equivalent

Hybrid cars with emissions 1-50g/km	2% of list price for cars with a battery range of >130 miles
	5% of list price for cars with a battery range of 70-129 miles
	8% of list price for cars with a battery range of 40-69 miles
	12% of list price for cars with a battery range of 30-39 miles
	14% of list price for cars with a battery range of <30 miles
Other cars	15% of list price for cars emitting 51-54g/km
	16% of list price for cars emitting 55-59g/km
	17% of list price for cars emitting 60-64g/km
	18% of list price for cars emitting 65-69g/km
	19% of list price for cars emitting 70-74g/km
	20% of list price for cars emitting 75-79g/km
	Increased by 1% per 5g/km over the 75g/km relevant threshold

Relevant % is reduced by 2% for cars first registered from 6 April 2020

Capped at 37% of list price (ie emissions of 160g/km or more for cars first registered before 6 April 2020 and 170g/km for cars first registered from 6 April 2020)

Diesel cars that meet the Real Driving Emissions Step 2 (RDE2) standard are treated as above, all other diesel cars have a 4% supplement added to the relevant percentage (subject to 37% cap)

Private fuel provided for company car

£24,500 x company car %

PAYE CODES

L	tax code with personal allowance
M	tax code with personal allowance plus claiming marriage allowance
N	tax code with personal allowance less surrendered marriage allowance
S	income taxed at Scottish rate of income tax
C	income taxed at Welsh rate of income tax
K	total allowances are less than total deductions
T	tax code includes other calculations to work the personal allowance, for example it has been reduced because estimated annual income is more than £100,000

NATIONAL INSURANCE CONTRIBUTIONS

	2020/21		
NIC CLASS 1 CONTRIBUTIONS	**Annual**	**Monthly**	**Weekly**
Primary threshold (PT)	£9,500	£792	£183
Secondary threshold (ST)	£8,788	£732	£169
Upper earnings limit (UEL)	£50,000	£4,167	£962

NIC CLASS 1 CONTRIBUTIONS		2020/21 Annual	Monthly	Weekly
Apprentice upper secondary threshold (AUST) for under 25s		£50,000	£4,167	£962
Upper secondary threshold (UST) for under 21s		£50,000	£4,167	£962
Employment allowance (per year, per employer)	£4,000			
Class 1 Primary contributions on earnings between PT & UEL	12%			
Class 1 Primary contributions on earnings above UEL	2%			
Class 1 Secondary contributions on earnings above ST where employee aged 21 or over and not an apprentice under the age of 25	13.8%			
Class 1 Secondary contributions on earnings between ST & AUST for apprentices under the age of 25	0%			
Class 1 Secondary contributions on earnings above AUST for apprentices under the age of 25	13.8%			
Class 1 Secondary contributions on earnings between ST & UST for employees under the age of 21	0%			
Class 1 Secondary contributions on earnings above UST for employees under the age of 21	13.8%			
Class 1A contributions	13.8%			

	2020/21
NIC CLASS 2 CONTRIBUTIONS	
Normal rate	£3.05 pw
Small profits threshold	£6,475 pa
NIC CLASS 4 CONTRIBUTIONS	
Annual lower profits limit (LPL)	£9,500
Annual upper profits limit (UPL)	£50,000
Percentage rate between LPL & UPL	9%
Percentage rate above UPL	2%

Syllabus area: Capital Gains

	2020/21
Annual exempt amount	£12,300
Gains falling within the remaining basic rate band	10%
Gains exceeding the basic rate band	20%
Basic rate band	£1 – £37,500

Syllabus area: Corporation tax

	FY 2020
Tax rate	19%
Augmented profits limit for corporation tax payment dates – large companies	£1,500,000
Augmented profits limit for corporation tax payment dates – very large companies	£20,000,000

CAPITAL ALLOWANCES

First year allowances available

100% on new and unused zero emissions goods vehicles

100% on new and unused low emission cars ie electrically propelled or with CO_2 emissions of not more than 50 g/km

100% on electric vehicle charging points

Annual investment allowance

£200,000 pa of expenditure incurred by any business on certain plant and machinery from 1 January 2021.

Writing down allowances

18% pa in the main pool

PAYMENT DATES

Payment dates for corporation tax	
Corporation tax	Nine months and one day after the end of an accounting period
Corporation tax by instalments – large companies	The 14th day of months 7, 10, 13 and 16 counted from the start of a 12-month accounting period
Corporation tax by instalments – very large companies	The 14th day of months 3, 6, 9 and 12 counted from the start of a 12-month accounting period

Syllabus area: Value Added Tax

VAT		
Standard rate		20%
Reduced rate		5%
Annual registration limit	From 1 April 2017	£85,000
Deregistration limit	From 1 April 2017	£83,000
VAT fraction (standard rated)		1/6

Cash accounting	£
Turnover threshold to join scheme	1,350,000
Turnover threshold to leave scheme	1,600,000
Annual accounting	
Turnover threshold to join scheme	1,350,000
Turnover threshold to leave scheme	1,600,000

Flat rate scheme	
Annual taxable turnover limit (excluding VAT) to join scheme	150,000
Annual total income (including VAT) to leave scheme	230,000

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